S
328.3
L13r14
1964

STATE DOCUMENTS

Montana State Library
3 0864 1004 3902 8

THE INVESTMENT OF PUBLIC FUNDS

A REPORT TO THE THIRTY-NINTH LEGISLATIVE ASSEMBLY

by the

Montana Legislative Council

December, 1964

McKEE PRINT

To Members of the Thirty-ninth Legislative Assembly:

This study contains the findings of the Council in an area which has been sadly neglected in the past— the investment of public funds. The Council reviewed the practices of the state's current investment programs both for treasury cash and permanent trust funds.

If the Council's recommendations to improve the investment of treasury cash are accepted, an estimated $200,000 of non-tax revenue will be paid into the general fund annually. If the proposed constitutional amendment is approved, and the programs anticipated by its approval are ultimately implemented, the investment of permanent funds and other trust funds could produce millions of dollars of additional non-tax revenue in the future.

Respectfully submitted,

W. A. "Bill" GROFF, Chairman

Montana Legislative Council

MONTANA LEGISLATIVE COUNCIL
1963-1964

SENATE MEMBERS

W. A. "Bill" Groff, Chairman
Edward T. Dussault
W. H. Grieve
John D. Melcher
Earl Moritz
Carl Rostad, Secretary

HOUSE MEMBERS

Henry S. Hibbard, Vice Chairman
Francis Bardanouve
Mark S. Etchart
W. L. Mathers
Leonard D. Regan
Ray J. Wayrynen

EXECUTIVE DIRECTOR

Eugene C. Tidball
State Capitol
Helena

SUBCOMMITTEES

Legislative Rules

Representative Henry S. Hibbard, Chairman
Senator W. A. Groff
Senator Robert A. Durkee
Senator Jack S. Brenner
Representative William E. Spahr
Representative Alex Blewett, Jr.

Liquor Control

Representative Ray J. Wayrynen, Chairman
Senator W. H. Grieve
Senator David F. James
Representative Leonard G. Bashor
Senator Carl Lehrkind, Jr.
Representative J. A. Turnage

Fidelity Bonds & Custodial Institutions

Representative W. L. Mathers, Chairman
Senator Earl Moritz
Representative Virgil L. Hanks
Senator Arnold Rieder
Senator Gordon McGowan
Representative Ralph J. Beck

Council Rules

Senator Edward T. Dussault, Chairman
Representative Mark S. Etchart

Investments

Senator Edward T. Dussault, Chairman
Representative Francis Bardanouve
Representative Leslie Eskildsen
Senator William R. Mackay
Senator A. Ronald McDonnell
Representative Norris Nichols

Personnel & Retirement Systems

Senator Carl Rostad, Chairman
Representative Leonard D. Regan
Senator Jerry W. Breen
Representative Malcolm E. Holtz
Senator Ward H. Beley
Representative Eugene C. Egan

Agency Fees & Property Classification

Senator John D. Melcher, Chairman
Representative Mark S. Etchart
Senator Jack S. Brenner
Senator Ed Carney
Senator Richard Nixon
Representative Walter Laas
Representative James P. Lucas
Representative Marshall H. Murray

Budget, Personnel & Meetings

Representative Francis Bardanouve, Chairman
Senator Edward T. Dussault
Senator Carl Rostad
Representative W. L. Mathers

TABLE OF CONTENTS

SENATE JOINT RESOLUTION NO. 8

Introduced by Brenner, Groff, Melcher, Dussault, Mackay, Durkee, Rostad

A JOINT RESOLUTION OF THE SENATE AND HOUSE OF REPRESENTATIVES DIRECTING THE LEGISLATIVE COUNCIL TO CONDUCT A STUDY OF STATE INVESTMENTS AND DEPOSITORY PRACTICES.

WHEREAS, the state of Montana presently has millions of dollars in the state treasury and in depository banks throughout the state, and

WHEREAS, under present investment practices employed in the state of Montana much of this money apparently is not drawing interest or does not otherwise produce any benefits to the state of Montana, and

WHEREAS, state government is increasingly hard pressed to raise the revenue necessary to keep abreast of an ever broadening and intensifying demand for governmental services,

WHEREAS, the prudent investment of state funds will increase state revenue without imposing any further tax burden upon the citizens of the state, and

WHEREAS, it is particularly appropriate that the legislative branch of government explore any possible new sources of revenue which do not also entail additional taxation.

NOW THEREFORE, BE IT RESOLVED BY THE SENATE AND THE HOUSE OF REPRESENTATIVES OF THE STATE OF MONTANA:

That the Legislative Council is directed to conduct a comprehensive study of

1. State depository practices, including the arrangements under which surplus cash, debt retirement funds, and other moneys are held in depository banks throughout the state.

2. Investment practices for state moneys including surplus cash, trust funds and all other moneys held by an agency of state government.

3. The organization and procedures of the State Board of Land Commissioners, the Commissioner of State Lands and Investments, the State Depository Board, and the State Treasurer, insofar as these organizations and procedures relate to the investment of moneys and,

4. The management of the states bonded and other indebtedness including practices involved in the floating of bond issues, use of bond proceeds and redemption of bonds; and

BE IT FURTHER RESOLVED, that the Legislative Council call upon members of the banking industry, the investment industry, for assistance and advice in its study and

BE IT FURTHER RESOLVED, that the Legislative Council engage any experts or consultants necessary to assist in its study and

BE IT FURTHER RESOLVED, that the Legislative Council report its findings and recommendations to the thirty-ninth legislative assembly, together with such bills and resolutions as may be necessary to implement its findings.

SUMMARY OF REPORT

Investment and depository practices involved in handling funds which are not deposited in the state treasury were not reviewed during this study. Moneys in the treasury which are available for investment can be grouped into two broad categories: (1) funds susceptible to long term investment and (2) treasury cash. The total amount of money in the state treasury available for investment is about $150 million.

The Administration of Long Term Investments

Most of the money available for long term investment—about $122 million—is held in trust by the state for the benefit of others. The four major funds involved are the Public Employees Retirement fund, the Teachers Retirement fund, Industrial Accident Board fund, and the Trust and Legacy fund.

Under the so-called "Unified Investment Plan," which was set up by statute in 1953, each one of these funds is supposed to be invested by the State Board of Land Commissioners. The laws are circumvented, however, and actually each of these funds is invested by a different state agency under different procedures. The Unified Investment Plan has proven ineffective; it has resulted only in an undesirable diffusion of responsibility. The State Board of Land Commissioners, which is vested with the legal responsibility for supervising investments, has abdicated its last thread of authority under the unified plan. It has become nothing more than a "rubber stamp" for the investing agencies.

For the four agencies which actually invest the money—the Public Employees Retirement System, The Teachers Retirement Board, The Industrial Accident Board and The Department of State Lands and Investments—investments is only a sideline. Each of the four administrators responsible for investments was hired primarily to serve in another capacity —as an administrator of a retirement system, as an accountant, or as manager of the state's agricultural and grazing lands. Each of the administrators spends a relatively small part of his time in the area of investments since the performance of his other duties demands full time attention. The portion of administrative costs devoted to investments by these agencies ranges from less than one-half of one percent to slightly over six percent.

No attempt was made to evaluate in detail every facet of performance of the four investing agencies. Generally speaking, and considering legal restrictions, the agencies seem to have performed quite well. Nevertheless, close examination of several aspects of the investments programs of the four agencies indicates that dynamic investment management has not been fully achieved. For example, a considerable amount of interest income is lost as a result of not fully investing idle cash.

The Council concludes that the lack of full time qualified investments personnel is the major deficiency of the state's investment program. The Council recommends that the administration of the investment of all state moneys be centralized under the supervision of professional qualified investments personnel. Where such systems have been established in other states they have proved highly successful and have been enthusiastically supported by the managers of separate retirement funds.

The Council proposes the creation of a separate state agency called the "State Investment Council." It would consist of five members appointed by the Governor, and the State Treasurer as an ex-officio non-voting member. One member would belong to the Public Employees Retirement System and would be nominated by the PERS board; a member of the Teachers Retirement System would be nominated by the Teachers Retirement Board.

The key to success of a centralized investment program is the investment officer. As one authority stated, "the only kind of investment advice which a fund cannot afford is poor advice. A good man in this post will save the systems many times his salary in the handling of

investment transactions." The proposed law requires that the investment officer have a minimum of five years of progressively responsible full-time paid experience in securities analysis and portfolio management. It is estimated that his salary will range between $15,000 and $20,000 per year.

The proposed legislation, if enacted, will permit boards of administration of the two retirement systems and other investing agencies to devote full attention to their primary duties. It will not impair any of their basic functions and will permit them to concentrate on their many other important responsibilities.

Restrictions on Investments Media

The Council also reviewed the restrictions on types of investments now authorized. The trust and legacy fund, which consists of some forty-seven million dollars, may only be invested in U. S. government bonds and municipal securities. The retirement systems and the industrial accident board may invest in government-insured mortgages and corporate bonds as well.

There is a definite movement into the corporate stock and bond market by public funds. By 1964 state retirement systems in twenty-eight states were partially invested in common stocks.

The main purpose of investing in common stocks is to maintain purchasing power of the income derived from investments. The public school fund in Montana is a good example of the degrading effects of inflation on fixed dollar obligations. In the past thirty years the fund has tripled from approximately $13 million to $38 million as a result of sale of state lands, oil royalties, and other income derived from the land. During this same period, while the fund tripled, interest income in constant dollars (adjusted to reflect purchasing power), decreased by almost one-third.

A security which cannot show capital appreciation cannot really preserve the principal because the principal only has meaning in terms of the goods and services that can be purchased with income from it. Inflation can diminish the principal just as a bad investment can. As one authority said, "The hazards of an aggressive program of investment in growth equities are no greater, it should be recognized, than the predictable loss that will be incurred through failure to adopt adequate counterinflationary measures in long range investment planning." The alternatives are either reduced services, or increased appropriations and higher taxes.

The Council recommends that the constitution be amended to remove the barriers against investing the trust and legacy fund and other funds in common stocks and other corporate obligations. The Council does not propose that the statutes be changed at this time since it feels that a centralized investment agency staffed by professional and experienced personnel should be established before the state begins a program of purchasing common stocks. If the constitutional amendment is approved, the 1967 legislature could authorize investing a portion of any of the funds in common stocks. Without the constitutional amendment it would even be impossible for the trust and legacy fund to purchase fixed income obligations such as government-insured mortgages or corporate bonds.

There will undoubtedly be some resistance to purchasing common stocks. Many persons, particularly those who recall the 1929 crash and the depression that followed, regard investment in common stocks as gambling or at the very least, speculative. However, failure to understand the reasons for individual losses in 1929 has resulted in much of the suspicion in common stocks. People "got burnt" in 1929 for a number of reasons, among which are

1. Failure to diversify
2. Trading for short term market swings
3. Buying on low margins
4. Wholesale distress selling at low point
5. Buying highly speculative stocks
6. Failure to pay reasonable prices for securities
7. Failure to analyze securities or retain professional counsel.

Another reason for resistance to the purchase of common stocks by public funds is the failure to recognize the fundamental difference between individual and institutional investment. The results for some individuals more than thirty years ago should not condemn stocks as an investment media for large, professionally managed retirement or permanent funds with characteristics and needs forming a completely different basis for investment activities. There is unanimous agreement among experts that a long-term holder of common stocks such as a public retirement or trust fund, can ride out storms and stresses, disregard intermediate market wings, and ultimately receive its compensation in the form of substantial income from dividends and market appreciation. A permanent fund is never faced with the necessity of selling its assets to cover marginal requirements or to buy groceries.

Treasury Cash Management and the Investment of Idle Funds

In addition to the long term investment of the retirement and trust funds, the Council also conducted an extensive study of treasury cash management and the investment of idle funds. In the state treasury there is on the average approximately $30 million in cash. A portion of this is needed to conduct the day to day business of paying state warrants but a good share of it is susceptible to short term, and in some cases long term investment.

The Council found that there is very little treasury cash management as such in the State of Montana, and that the absence of an imaginative and vigorous investment program over the years has resulted in a loss of millions of dollars of non-tax revenue.

The Council recommends that the state investment council referred to earlier, and its investments officer, be given responsibility also for the investment of treasury cash. A program for the management and investment of idle cash could be coordinated with long term investments and supervised by the same personnel. The Council estimates that additional annual interest income in excess of $200 thousand would accrue to the state if idle cash were properly invested.

INTRODUCTION

This study was authorized by Senate Joint Resolution No. 8, approved during the 1963 session. The following four specific areas to be reviewed by the Council were mentioned in the resolution.

1. State depository practices, including the arrangements under which surplus cash, debt retirement funds, and other moneys are held in depository banks throughout the state.
2. Investment practices for state moneys including surplus cash, trust funds and all other moneys held by an agency of state government.
3. The organization and procedures of the State Board of Land Commissioners, the Commissioner of State Lands and Investments, the State Depository Board, and the State Treasurer, insofar as these organizations and procedures relate to the investment of moneys, and,
4. The management of the state's bonded and other indebtedness including practices involved in the floating of bond issues, use of bond proceeds and redemption of bonds.

Apparently the legislature authorized the study in the hope of reforming investment practices to produce more interest income for the state; however, there are several other related matters included in the above list.

The Council reviewed state depository practices only insofar as treasury funds are concerned. An inventory of all moneys in the custody of state agencies which are not cleared through the state treasury is badly needed. In 1962 the Council commented on the significant amounts of money held outside the state treasury.

> ***In some instances there may be adequate justification for keeping moneys on local deposit; but when public moneys are collected and disbursed without ever touching the treasury, the work of preparing a comprehensive budget and establishing adequate fiscal control is greatly increased, if not made impossible. Depository practices and other procedures involved in handling public funds outside the treasury appear to be fertile areas for future study.***[1]

A review of investment practices relating to treasury funds presented a sufficiently large task for one interim. Either the State Controller or State Budget Director, both of whom are directly involved with expenditure control, should review the practices involved in holding moneys outside the treasury. After an inventory is compiled the investment implications will be more readily apparent.

Management of the state's debt also has implications beyond those related solely to investment. The need for improvement in this area was mentioned by the Council two years ago.

> ***Often there is no one official specifically authorized to control the use of bond proceeds or to administer revenues earmarked for debt service. The process of floating and retiring bond issues is so decentralized that the status of the state's bonded indebtedness is not known; sizeable debt service expenditures never pass through the state treasury.***[2]

The Council went on to suggest that the official responsible for investments "could be given the responsibility of approving the terms of all bond agreements or indentures, overseeing use of the bond proceeds, investing surpluses in sinking fund accounts, and redeeming

[1] Montana Legislative Council, *State Treasury Fund Structure,* Report No. 9, (1962), p. 21.
[2] *Ibid,* p. 9.

bond issues on terms most advantageous to the state." However, the Council feels that the necessary first step is to establish a central investment agency. Once the office is established and operating smoothly it could well be assigned some responsibilities in this area.

Because of the technical nature of this study and because of the availability of many experienced investments personnel, the Council found it desirable to call upon a number of these people for their assistance. The Council is especially grateful to Russell C. Maclin of the Institutional Department of Merrill Lynch; John C. Weiner, Jr., Vice President of Moody's; and K. Lee Martyn, also of Moody's, who traveled to Helena from New York and Chicago at their own expense to meet with the Council's investments sub-committee, and to Ian Davidson of D. A. Davidson & Co. who provided the Council staff with helpful information and advice.

The Council also appreciates the cooperation of Andrew Kiely, Chief Accountant of the Industrial Accident Board, John Sasek, Secretary of the Public Employees Retirement System, Hugh McKinny, Executive Secretary of the Teachers Retirement System, and Mons Teigen, Commissioner of State Lands and Investments, in providing financial data and information on the investment practices of their agencies.

The portion of the study relating to treasury management and the investment of cash was conducted with the assistance of a committee of the Montana Bankers Association. The fairness and cooperation of this committee in reviewing depository practices was of great help in this study. As usual, State Treasurer Edna Hinman was congenial and cooperative in assisting the Council with obtaining information on matters relating to the operation of the state treasury.

A special word of thanks is owed to a task force composed of Montana State University School of Business Administration's faculty members which assisted the Council in this study. Professor Fred Henningsen compiled cash flow data which was invaluable to the Council. Maxine C. Johnson, Assistant Director of the Bureau of Business and Economic Research, and Professor Robert Haring, along with Professor Henningsen attended most of the Investment subcommittee's meetings, and offered helpful suggestions throughout the course of the study.

Chapter I

THE ADMINISTRATION OF LONG TERM INVESTMENTS

Funds susceptible to investment for periods of one year or more fall into four general categories: (1) permanent funds, (2) pension funds, insurance reserves, and other moneys which the state holds as an agent or trustee, (3) sinking funds, and (4) surplus operating revenue earmarked for the use of a specific state agency. A portion of the surplus cash in the treasury may also, from time to time, be invested for long terms, but this category is reviewed in Chapter III of this report.

The responsibility for long term investments lies with four state agencies. The State Board of Land Commissioners is responsible for investing the trust and legacy fund, which consists primarily of moneys derived from federal land grants for educational purposes, and also invests sinking funds and surplus operating moneys under the control of other state agencies; the Public Employees' Retirement System and Teachers' Retirement System are each responsible for investing their own pension funds; the Industrial Accident Board invests its insurance reserve funds.

The total amount of money invested by these four agencies is approximately 123 million dollars.

The Historical Development of Investments Administration

Initially, the only sizeable inactive funds in the state treasury arose from land grants, and the State Board of Land Commissiners was the sole agency responsible for long term investments. In 1915 the governing board of the newly created Teachers Retirement System was empowered to invest the teachers retirement fund.

As it became apparent that other idle moneys could be earning interest income, the Legislative Assembly delegated power to invest certain sinking and operating funds. In 1921 the Board of Examiners was authorized to invest six funds, including the fish and game fund;[1] however, a proviso was shortly added "that no moneys shall be taken from the Fish and Game Fund except with the consent of the Montana Fish and Game Commission."[2] The fragmentation of authority was well on its way.

In 1924, 18 sections were added to the Montana constitution as Article XXI. Apparently the main purpose of this article, which created the Montana Trust and Legacy Fund, was to establish a unified system for investing permanent funds, and to provide machinery for the acceptance of gifts and donations to the state.

In 1929 the Legislative Assembly approved an act which established a "Unified Investment Plan" and which spelled out in detail the procedures to be followed in investing the trust and legacy fund. The act also permitted other departments of the state to voluntarily use the services of the State Board of Land Commissioners as an investing agency. However, the act expressly exempted permanent land grant funds from the unified investment plan. All funds included in the unified plan were to be administered as one common fund for the purposes of investment.

Commissioner of State Lands and Investments, I. M. Brandjord, reported in 1934 that his department was charged with the investment of twelve funds but added that "there is also a

[1] Chapter 1, Laws of Montana, 1921, p. 1.
[2] Chapter 122, Laws of Montana, 1925, p. 213.

considerable number of more or less permanent funds subject to investment under the administration of various state boards and offices."[3] Commissioner Brandjord proposed an amendment to the constitution to include in the trust and legacy fund all permanent funds arising from federal land grants to the state and suggested that "the plan should be made so comprehensive as to permit the investment of every fund under the administration of the state subject to investment."[4] The commissioner justified his recommendation as follows:

> ***The unified investment plan here recommended does not represent a new-fangled idea; it is not an untried scheme; on the contrary, it is a tested plan that has been followed by every bank and banker throughout civilization for centuries. How could a banker transact business if he had to find a suitable investment for each separate deposit? The unified plan has been found absolutely necessary for investments made by banks and bankers. This bill proposes to extend this plan in the investment of funds under the administration of the state.***

A 1938 amendment to Article XXI of the Montana constitution incorporated all permanent funds arising from federal land grants in the trust and legacy fund. However, when the Public Employees Retirement System was created in 1945 the governing board was given exclusive control of investing the pension fund.

Some fifteen years later the Commission on Reorganization of State Government of the State of Montana, popularly known as the "Little Hoover Commission," observed that the following state agencies were responsible for investing public moneys: State Land Board, State Board of Examiners, Public Employees Retirement Board, Teachers Retirement Board, Industrial Accident Board, Highway Patrolmen's Retirement Board, and State Depository Board.

The Commission proposed to the Legislative Assembly in January of 1953 that all state moneys, including those held by retirement systems and the State Treasurer, be invested by the State Board of Land Commissioners under the Unified Investment Plan. The committee hoped that this plan would:

1. Eliminate duplication of offices and personnel.
2. Provide a better overall administration and tend to greater economy in operations.
3. Make it possible to provide at a minimum cost an adequate investments staff with technical advice, market data, and financial services.
4. Make possible the pooling of small funds so as to secure better securities and the transferring of a security from one fund to another when one fund is buying and the other selling, resulting in greater stability and making it possible to invest closer to the total amount of money available.[5]

The Legislative Assembly accepted these recommendations and, with the passage of Chapter 176, Laws of 1953, amended the unified investments plan into substantially its present form.

The unified investment plan places three investment funds under the control of the State Board of Land Commissioners. Each fund is subject to different restrictions as to permissible types of investments.

(1) The Montana Trust and Legacy fund consists of the permanent school fund ". . . and all other public funds of the state subject to long-term investment not legally in the custody of any lawfully constituted board or the investment of which has not been desig-

[3] *Report of the Commissioner of State Lands & Investments*, Dec. 1934, p. 78.
[4] *Ibid.*, p. 78.
[5] Commission on Reorganization of State Government of the State of Montana, *Report to the Thirty-third Legislative Assembly*, (1953), pp. 46-47.

nated by statute." Interest income is credited pro rata to the various accounts constituting the Montana trust and legacy fund, which is the only fund of the three actually invested as a single fund.

(2) The Long Term Investment Fund consists of that part of the highway patrolmen's retirement fund in excess of $25,000, the public employees retirement fund, the industrial accident reserve fund, all funds subject to investment as designated by the Teachers Retirement Board, that part of the fish and game fund which is available for investment, "and all other funds designated by statute."

(3) The Short Term Investment Fund consists of any surplus cash in the office of the State Treasurer; any money in any state bond sinking and interest fund not required for the immediate payment of bonds, principal, or interest; any educational bonds interest and sinking fund; any of the Montana highway patrolmen's retirement fund less than $25,000 and any other fund designated by statute to be invested, or any fund in the custody of a city, county, or school district if the investment of the fund is requested by the officer or governing body. Any state department having investable funds under its administration must have them invested by the State Board of Land Commmissioners.

The law authorizes the Board to employ an expert on financial matters to advise on investments, but limits the salary to $1000 annually. A local banker was retained for a brief period in 1957 but limited his activity to verifying investments already made by the Commissioner of State Lands and Investments.

Investments Procedures

MONTANA TRUST AND LEGACY FUND

A list of bond offerings is presented to the State Board of Land Commissioners at its monthly meeting. The Board authorizes the Commissioner to bid on these issues, but in most instances he has already done so. Since the Board usually meets only once a month, bond issues could be announced and the sale held before the Board could act. Consequently, the Commissioner actually bids and purchases bonds, and the Board ratifies his action.

The bond and right-of-way clerk in the Department of State Lands and Investments actually invests the trust and legacy fund. Usually one of the local banks is consulted prior to purchasing U. S. treasury securities. Article XXI of the Montana constitution designates the Montana Supreme Court as a supervisory board for the Montana trust and legacy fund; the Court receives annual statements of the status of investments in the trust and legacy fund but has never exercised any supervision over the investment program.

Thus, the State Land Board neither invests the trust and legacy fund nor always reviews the investments after they are made. The full burden of investing the trust and legacy fund falls on the Commissioner of State Lands and Investments and his subordinate employees.

LONG TERM INVESTMENT FUND

Under the unified investment plan the Board of Land Commissioners is also required to invest the moneys of the long term and short term investment funds. Included in the long term investment fund are the pension funds of the Public Employees Retirement System and the Teachers Retirement System, and the insurance reserve funds of the Industrial Accident Board. Each of these funds, however, is actually invested under varying procedures by employees of the respective departments.

The Public Employees Retirement System operates through an investments committee consisting of three members of the governing board, the consulting actuary, and the secretary to the board. The chief accountant of PERS sits in on meetings in an adivsory capacity.

The committee meets several times monthly, whenever money is available for investment. At a typical meeting, the secretary distributes individual offering sheets for mortgages, recent photographs of the properties, and credit reports on the mortgagors. This material is circulated among members of the committee who examine the photographs and read the credit reports. After deciding how much money should be invested in mortgages, the committee reviews offering sheets and other data distributed by the secretary relating to corporate utility bonds and equipment trust certificates, and determines the extent of investments in these media.

The Teachers Retirement Board has an investments committee composed of the executive secretary of the system, the Superintendent of Public Instruction, and the consulting actuary. However, the committee seldom meets because the Superintendent of Public Instruction is too busy with other duties and cannot attend meetings. The executive secretary and the consulting actuary decide on investments by telephone conversation and buy and sell on that basis.

The chief accountant of the Industrial Accident Board recommends investments to the Board after consulting with an employee of the trust department of one of the Helena banks and with the Board's consulting actuary. He then reports to the Board which bases its final decision on his recommendation.

After these decisions are reached by the respective agencies, the Commissioner of State Lands and Investments is immediately sent a list of the proposed investments. If the investments appear to be legal, the Commissioner stamps "approved" on the face of the letter and returns it. The money is invested, and the Commissioner secures the retroactive approval of the State Board of Land Commissioners at its next meeting.

The Commissioner also invests some of the sinking funds of university units as well as moneys of several operating agencies such as the State Depository Board, Montana Highway Patrolmen's Retirement Board, the War Veterans Honorarium, Livestock Sanitary Board, the Hail Insurance Board, and the Fish and Game Commission. These investments are requested by the department heads, who generally recommend their choice of investments. The Commissioner does not invest these moneys on other than a request basis, since he does not know how much money the departments have on hand or what their cash needs are. Generally, the Board of Land Commissioners approves these investments retroactively, although there are instances of some investments which have never been approved by the Board.

Evaluation of Procedures under the "Unified Investment Plan"

The "Unified Investments Plan" has proven ineffective; it has resulted only in an undesirable diffusion of responsibility. The investment of public funds continues substantially as it has for the past two or three decades, except for the addition of several superfluous procedural steps.

The State Board of Land Commissioners, which is vested with the legal responsibility for supervising investments, has abdicated its last shred of authority under the unified plan. Each agency invests as it pleases, securing the "rubber stamp" approval of the Commissioner of State Lands and Investments prior to the purchase or sale of securities. The "rubber stamp" ratification of the State Board of Land Commissioners is automatically obtained after the transaction has been completed. Neither the Commissioner or the State Board has any voice in establishing investment policy or supervising investment practices, except in the case of the trust and legacy fund and a few minor operating and sinking funds. In fact, the participation of the Board and Commissioner actually impedes good investments administration. If the Commissioner leaves town, one of the investing agencies might have to delay a major transaction for four or five days awaiting his approval.

Neither has the Board provided the imaginative leadership which is expected of a policy making body. The continuation of the policy of submitting automatic bids on all municipal and school district issues, and the failure to request broader investment authority from the legislature, are examples of stagnation in the investment program under its jurisdiction.

A specific instance of inattention to the investment program was the Board's failure to resolve the question of whether securities could be traded at less than purchase price or face value. In 1960 the Legislative Council noted that

> ***Whether securities could be sold at face value or more than face value but less than purchase price, or whether securities could be sold at purchase price or more than purchase price but less than face value is open to question. Persons familiar with the management of investments agree that it is impossible to administer the investment of government securities effectively unless selling at a loss is permitted. It is sometime necessary to sell securities at a loss in order to purchase other securities with higher yields. Such losses are only temporary; net earnings are increased through higher yields.***[6]

In order to determine whether a constitutional amendment was necessary to give the Board the critical power to sell at a loss, the Legislative Council, in 1963, found it necessary to request an advisory opinion from the Supreme Court in its capacity as supervisory board of the trust and legacy fund. In its opinion *Re Montana Trust and Legacy Fund,* the Court said that securities held in the trust and legacy fund could be sold or traded for less than purchase price or face value, with minor exceptions.

It is obvious that an ex officio board or committee can never satisfactorily function as an investing agency because of inability to devote the necessary time to ex officio duties, and lack of assurance that members will have any knowledge of the investments field.

> ***First, it is elementary that a state will get expert investment management only by employing qualified talent. In this age of specialization it is no longer rational to leave the investment of state funds to ex officio committees or bodies made up of state officials already overburdened with their major jobs and who have insufficient spare time to become expert in a 'side line' function.***[7]

As a result, the four agencies have established diverse investment procedures and standards and employ their own personnel to supervise investment programs. The separate administration of four major investment programs in state government has obvious disadvantages, among the most important of which is duplication of personnel. The independent investment programs force administrators, whose primary functions lie elsewhere, to develop some degree of proficiency in the field of investments.

Each of the four administrators was hired primarily to serve in another capacity—as an administrator of a retirement system, as an accountant, or as manager of the state's agricultural and grazing lands. Each of the administrators spends a relatively insignificant part of his time in the area of investments, since the performance of his other duties demands full time attention.

With each of these four agencies—the Department of Lands and Investments, the Public Employees Retirement System, the Teachers Retirement Board, and the Industrial Accident Board—investing is only a sideline. The approximate percentages of total administrative costs devoted to investments by each of these agencies is as follows:

Department of Lands and Investments	1.3%
PERS	2.9%
Teachers Retirement System	6.1%
Industrial Accident Board	0.4%

[6] Montana Legislative Council, *State Lands and Investments,* Report No. 4 (1960), p. 52.

[7] National Municipal League, *Model Investment of State Funds Law,* (1954), p. vii of Introduction.

Thus, the investment programs of these agencies are accorded a minor and, in some cases insignificant, share of administrative costs; yet to increase agency expenditures would only compound the duplication of effort that already exists.

Each agency must also maintain extensive records; those agencies that purchase mortgages have extra burdens of field inspections, audits and bookkeeping. Interviews with securities dealers can be a burdensome nuisance for all administrators.

The committee approach to the purchase and sale of securities employed by PERS is impractical. Even if the committee members possessed the special qualifications necessary to make these decisions, which they do not, transactions would be delayed to the point of interfering with the effective investment of available moneys. The responsibility for buying and selling must be delegated to a person or group of persons who can meet immediately and act immediately. At one meeting the committee was told that some government bonds which they might have wanted to sell could have been disposed of at a profit "last week" but that it was "too late now." Between the time money becomes available for investment and a desirable issue is located, and the time when all committee members are located and drive to Helena, the entire picture might have changed. A committee should establish general policy and impose any necessary limitations on the investments administrator, who, within these limitations, should have full authority to buy and sell at a moment's notice when dictated by market conditions.

> ***Management of investment funds also requires a clear delegation from the retirement board or investment committee to the investment counselor or manager. Purchases which must be specifically approved at periodic committee meetings cannot usually include the best values. Values come and go and do not wait upon the convenience of committees. Formal meetings are essential to review and criticize past activities and to lay down general policies for the next few weeks or months. They should never intrude upon the selection of specific issues. If they do, the fund becomes a captive buyer entirely at the mercy of the syndicate pricing the bonds and is forced to pass up better values for the approved issues.***[8]

The reasons for the procedure employed by PERS are probably identical to those attributed to the Oregon Public Retirement System, which also employed a committee system.

> ***The fact that the retirement board has not delegated to one person authority to act immediately, if necessary to make optimum purchases, could be due to the lack of an investment manager or investment counselor or to non recognition of the importance of propitious timing in investment management.***[9]

While the practice of telephone consultations employed by a two member majority of the Teachers Retirement Board Investment Committee subverts the procedure established by the Board, it is at least a workable system.

Evaluation of Investments Administration

The Council has not attempted to evaluate in detail every facet of performance of the four investing agencies. The ultimate test is net effective interest earnings, but even this criteria must be weighed against the possibility of even greater earnings if investment decisions had been different, and against the all important standard of safety of principal. But looking backwards is always risky, even for experts; by hindsight one always has 20-20 vision.

Diverse accounting methods are employed by three of the agencies; the records of the Department of Lands and Investments are hopelessly inadequate. Consequently, an earnings

[8] Oregon Legislative Fiscal Committee, *Investment Management*, Nov. 15, 1962, p. 38.
[9] *Ibid.*, p. 41.

rate cited by an agency is difficult to evaluate. Variations in the method of amortizing premiums, for example, could result in significant variations in earned interest figures. Whether or not administrative costs are charged against earnings is also critical. The difference between gross and net interest may be substantially the difference between adequate and inadequate return.

Because of the extensive audit which would be necessary, an independent determination of net interest rates was not attempted. PERS reports an earnings rate of 4.09%, Teachers Retirement System 4.1% and Industrial Accident about 3.5%. In 1960 the Legislative Council estimated the "apparent rate of return" on the trust and legacy fund at about 2.8%, but recent increases in interest rates may have raised this to slightly over 3%. Considering legal restrictions, the agencies seem to have performed quite well.

In fact, due to a heavy reliance on mortgages, the two retirement systems have attained a respectable rate of return which should rise because of recent heavy sales of municipal bonds and reinvestment in mortgages and corporate obligations. The two retirement systems should be commended for their early entry into the mortgage field, something which retirement systems in some other states failed to do even after permissive legislation was enacted. Their successful attempt to secure legislation permitting investment in corporate bonds and the subsequent liquidation of municipal holdings also deserve commendation.

Nevertheless, a close examination of several aspects of the investments programs of the four agencies indicates that dynamic investment management has not been fully achieved.

The Department of Lands and Investments regards as its primary job the management of over five million acres of state lands. Most of the responsibility for investing the $47 million trust and legacy fund falls on the bond and right-of-way clerk, who devotes about two-thirds of his time to right-of-way problems on state lands. The department has no idea what rate of interest has been attained on its investments. This indifference to the results of the investment program is a good indication of the department's attitude toward this "side line function." The lack of adequate records is startling.

> ***Another facet of state trust fund administration which suffers because of a lack of trained personnel is the records and control system. In order to furnish the Legislative Council with an inventory showing the face value, purchase price, date of purchase, interest rate, redemption date and unpaid balance of all investments the Department of State Lands and Investments found it necessary to hire a special temporary employee to search the records. The department was unable to determine the purchase price of one group of U. S. bonds with face value of $1,400,000. Improving the inadequate records system should be of first priority if reform of the investments procedures is contemplated.***[10]

Inadequate records may also have been responsible for the deficient control which the Legislative Council in 1960 cited as "an exmple of faulty management which undoubtedly could have been avoided under a more efficient investment program supervised by experienced personnel." In this instance there was some confusion between the Treasurer's office and the Commissioner of Lands and Investments as to who was supposed to be watching maturity dates. As a result of each department waiting for notification from the other, the state lost interest in excess of $1,250.

The Public Employees Retirement System investments committee sometimes attempts to make investments decisions when it has before it incomplete or conflicting information on

[10] Montana Legislative Council, *State Lands and Investments,* Report No. 4, (1960), p. 55.

call dates, price of securities, and ratings. For a meeting less than two months after legislation was enacted permitting the investment of the retirement fund in corporate bonds, the minutes show the following entry:

> After careful inspection of all offerings, and noting particularly the bond ratings, it was moved by Mr. Young that the retirement system purchase $121,000.00 of Triple A-rated American Telephone and Telegraph 5% debentures, at 107 to yield 4.48 from Piper, Jaffray and Hopwood Co., Minneapolis, Minnesota subject to the approval of the State Board of Lands and Investments.

Most corporate bonds carry "call dates," the earliest possible date which the issuing corporation may redeem the bond at a specified price. When dealing in bonds, protection against early call can be as important as price and yield. Determination of the call date was neglected by the investment committee, and the bonds were called two months after purchase. The loss in principal and interest earnings to the retirement fund exceeded $500. The committee, in the words of one of its members, "was not aware of call dates" at the time of the purchase.

Perhaps the most significant evidence of inattention to investment possibilities by the four agencies, was revealed by a cash flow study conducted by the Council for the period July 1, 1961 to June 30, 1963. The income and expenditures for this period were analyzed to determine if the administrators were effectively utilizing idle cash which is held temporarily by the agency before investment in long term securities or expenditure.

In each of the four funds monthly receipts are normally more than adequate to cover monthly expenditures. This indicates that cash balances carried by these funds might well be held to a bare minimum in order to maximize earnings.

CASH BALANCE DATA—BY FUNDS

For the Period July 1, 1961—to June 30, 1963

	Ind. Acc.	PERS	TRS	T & L
Average Cash Balance	$ 707,175	$ 241,915	$ 350,117	$ 486,083
Highest Balance	1,536,071	478,861	744,564	1,091,459
Lowest Balance	133,000	45,539	61,770	101,803
Average Balance invested to yield 2.4%	18,171	6,206	8,405	11,665

Assuming that with careful management idle cash balances could be invested in short term U. S. treasury bills to yield at least 2.4% per annum in nearly perfect safety it is obvious that significant income is lost each year by carrying more than adequate balances with the State Treasurer.

Not included in the table above is the social security fund held by the PERS which over the same period had an average balance of $372,490. Invested at 2.4% the annual yield would have been $8,939. Apparently PERS began investing these surplus funds in U. S. Treasury bills in December, 1963, ten years after social security coverage began. With this addition, the total annual loss in interest income as a result of not fully investing idle cash by these four agencies totals approximately $53,000. If cash in the state treasury were being invested for

maximum return, this income would not be lost, but the general fund would gain at the expense of these four funds. However, as will be shown later in this report, the state is receiving little more than a nominal rate of interest on its treasury cash.

The reasons for this loss of income became apparent when administrators of the four agencies were interviewed on July 1, 1963. The Commissioner of Lands and Investments was holding $500,000 on instructions from the State Board of Land Commissioners. The reason given was that "this building program the state is embarking on is going to require some money out of our capitol building fund and we are holding this money to use for that rather than have it tied up and then have to take it back out." However, the contract for moving state agencies out of the construction area was not even let until two months later, and construction did not begin until November 27, 1963.

The Teachers Retirement System builds up a substantial cash balance in June to defray expenses during the summer when income drops off. On July 1, 1963 the balance was $395,000, but the Executive Secretary firmly opposes purchasing short term treasury bills with staggered expiration dates, even though income and expenditures for the summer months are easily predictable.

The Industrial Accident Board allows its cash balance to build up to $600,000 before investing—then a $300,000 bond is purchased. The reason given is that a catastrophe might occur and two or three hundred thousand might be needed right away.

The executive secretaries of the two retirement systems, the Commissioner of State Lands and Investments, and the chief accountant of the Industrial Accident Board are men of experience and ability with a strong sense of loyalty to the agencies they serve. Each one appears to be doing a thoughtful and enthusiastic job. The fact remains, however, that the investment management function needs more than a portion of the time and energy of an administrator whose major duties lie in another field.

> ***An executive secretary with the usual many duties and responsibilities within the cognizance of his position makes it advisable to have a separate position of investments manager. Part time retirement board members, even when experienced in the investment field, cannot usually devote the time or provide at the appropriate time the decisive action essential to dynamic portfolio management. The acquisition of expert counselling will permit more attention to items of portfolio management such as rotation analysis of the maturity schedule on bonds and protection against early call.***[11]

Investments Personnel

The lack of full time qualified investments personnel is a major deficiency in the state's investments program. "It is disastrous to delegate the responsibility for actual investments to well-meaning but definite amateurs in a field where technical skill is required."[12] The consulting actuary for the two retirement systems and the Industrial Accident Board apparently provides some investment advice. Banks and securities dealers advise the administrators, but no continuous professional investment service or counsel is retained.

In 1960 the Legislative Council noted, "Until experienced investment personnel are employed by the state, little can be done to increase the return on the state's investments . . ."[13] The Council said an example of the kind of gains that can be realized by the state through such experienced personnel was a trade of U. S. governmental bonds which was devised by experi-

---

[11] Oregon Legislative Fiscal Committee, *Investment Management* (1962), p. 44.

[12] National Municipal League, *Model Investment of State Funds Law*, (1954), p. viii of introduction.

[13] Montana Legislative Council, *State Lands and Investments*, Report No. 4 (1960), p. 54.

enced investment people and voluntarily proposed to the State Board of Land Commissioners. As a result of the exchange the state will receive additional annual interest income of $100,000 or a total of $2 million over the life of the bonds.

> ***Investment is as technical a field as that of medicine, law, accounting, or engineering. Investing other people's money is a job which requires the highest professional and fiduciary qualifications and standards. This is not a part time task. It requires continuous application because of the dynamic character of the constantly changing markets and earning situations.***[14]

There is little disagreement that an experienced investments manager must be employed before the state embarks on a program of purchasing common stocks. It is also quite obvious that investment of the various funds involved must be centralized to make such employment economical. While the broadening of investment authority is conditional upon the employment of an experienced, professional investments manager, it appears that regardless of whether or not restrictions are removed, a thoroughly trained investment man operating in the government and corporate bond market would produce beneficial results. The Legislative Council in 1960 recommended that ". . . eventually all state funds subject to investments be placed under the supervision of an experienced investments person with adequate staff and advised by an investments counsel. *It is believed that even under the present restrictions on the investment of the trust and legacy fund, savings and increased income would offset the expense of such a program.*"[15]

Employment of a professional investments manager would not deprive the various agencies having money available for investment of any of their primary managerial functions. Each of the agencies would retain control over their funds until they were declared available for investment.

The State of New Jersey established an investments council in 1950 which assumed responsibility for investing funds which were formerly invested by eight different boards of trustees. Fund administrators report on the consolidation favorably. The secretary of one pension fund stated:

> ***I must say that I have not heard anyone comment that they preferred the investment arrangement that was in effect prior to the creation of the [Investment] Division. Certainly the Division with its vast sums available has been able to secure larger yields for the funds through direct negotiation with corporations and other means.***
>
> ***I would sum up my opinion by saying that I feel a consolidated administration of investments is favorable to individual management. Perhaps one of the most outstanding features of the consolidated plan is that the administrator over investments is a specialist and the administrators of the individual funds cannot be specialists in all the subjects they are required to deal with.***[16]

A member of the New Jersey Teachers Pension and Annuity Fund, who has served on the board since 1938 and has observed the assets grow from $70 million to over $500 million, said, "In my experience under both systems, I am definitely of the opinion that the present New Jersey system is far superior to the previous system."[17]

---

[14] Oregon Legislative Fiscal Committee, *Investment Management*, (Nov. 15, 1962) p. 55.

[15] Montana Legislative Council, *State Lands and Investments*, Report No. 4, (1960), p. 56.

[16] Correspondence, Mr. Christopher F. Carson to Mr. Eugene C. Tidball, May 15, 1964.

[17] Correspondence, Mr. Harold Ray to Mr. Eugene C. Tidball, May 19, 1964.

Investments Administration in Other States

NORTH DAKOTA

In 1961 the North Dakota legislative research committee conducted a study of investment practices and recommended the creation of a state investment board to invest all funds except those which could not be placed under the management of the board because of constitutional restrictions. The board would appoint a director and other personnel to carry on day to day investment activities.

NEBRASKA

The Nebraska legislative council recommended in 1960 that legislation be introduced to establish a state investment board to be charged with the investment of the state's retirement funds, the temporary reserve funds and the current operating funds of the state.

WASHINGTON

In 1959 the Washington legislative council recommended passage of a bill creating a state investment council which would appoint a state investments officer to conduct the investment program.

OREGON

The legislative fiscal committee of the Oregon legislative assembly recommended in 1962 the creation of an investment council which would select an investments officer to conduct the investment program for all state agencies investing moneys.

NEW MEXICO

In 1959 New Mexico created a state investment council which has responsibility for investing the permanent funds of the state.

OHIO

The Ohio legislative service commission recommended in 1963 that consideration be given to a central investments service unit to handle the administrative and research work necessary for effective investments administration. The advantages of the unit would be found, the report said, "in a possibility of getting a highly competent investment man to head the unit with adequate staff for carrying out the policies of the respective retirement systems, and for research and study of the performance of portfolios in order to keep the boards informed on an increasingly varied and complex subject."

SOUTH DAKOTA

In 1958 a committee of the South Dakota legislative research council recommended the establishment of a five member investment board.

NEW JERSEY

New Jersey was among the first of the states to establish a central investments administration. An investment council created in 1947 is responsible for investing the major funds of the state including those of the four principal retirement systems.

MINNESOTA

In 1959 Minnesota established a consolidated investment department which is responsible for investing six retirement funds, the permanent school fund and several other permanent funds.

WISCONSIN

Wisconsin created an investments board in 1951 which operates a consolidated investment account for all separate operating funds that are subject to appropriation by the legislative assembly, as well as for trust funds.

Conclusions and Recommendations

The two most apparent deficiencies in the state's long term investment program are: (1) the decentralization of administration, and (2) the lack of professional, qualified investments personnel.

The "Unified Investment Plan" exists only in name. A major reason for the failure of the plan was the unrealistic limitation of one thousand dollars to be paid for investment counsel. Because the State Land Board was never equipped with a professional staff, agencies responsible for other funds had no confidence in the ability of the Board to invest the moneys, and as a result ways and means were found to circumvent the intent of the law. An exaggerated proprietary attitude toward funds under their control was also a contributing factor in the unwillingness of these agencies to relinquish control over investments.

The Council recommends that the legislature create a separate state agency to supervise and administer the investment of all state moneys. The proposed legislation, which appears in *Appendix A*, would establish a state investment council consisting of five members appointed by the governor, and the State Treasurer as an ex officio non-voting member. One member would belong to the Public Employees Retirement System and would be nominated by the PERS board. A member of the Teachers Retirement System would be nominated by the Teachers Retirement Board.

The key to the success of a centralized investments program is the investment officer. "The only kind of investment advice which a fund cannot afford is poor advice . . . A good man in this post will . . . save the systems many times his salary in the handling of investment transactions . . . No greater contribution to the economical and effective investment management of these systems can be made than by the provision of competent staff."[18] The proposed law requires that he have a minimum of five years of progressively responsible, fulltime, paid experience in securities analysis and portfolio management. The law is written in such a way as to provide that the investments council establishes policies, but the state investment officer, subject to any limitations contained in these policies, may buy, sell and exchange securities.

> ***First of all, it seems axiomatic that in this dynamatically changing economy, the best investment results in any fund, private or public, will be achieved only by thoroughly trained and competent investment managers. This will be true whether or not constitutional and statutory restrictions relating to Montana funds are removed . . . Investment managers of this type will command in this market a salary of $15,000 to $20,000 annually. But regardless of whether or not the restrictions are removed, a thoroughly trained investment man operating in the government bond market, as well as the municipal market, would undoubtedly produce beneficial reults.***[19]

The proposed legislation, if enacted, will permit the Board of Administration of the Public Employees Retirement System, the Teachers Retirement Board, the State Board of Land Commissioners and the Industrial Accident Board to devote full attention to their primary duties.

> ***Centralization of the investment function does not impair any of the other powers of the various boards, commissions or agencies administering state funds. Relieved of this function, which is separable, these bodies can then concentrate on their many other important duties and responsibilities, whether they relate to administering a workmen's compensation insurance system, or to passing upon employee retirement applications. Most board members would welcome the opportunity to concentrate upon their major substantive responsibilities.***[20]

---

[18] Roger F. Murray, *Report to the Ohio Legislative Commission on the Retirement Systems of the State of Ohio,* (1962), p. 7.

[19] J. H. Dion, *Maximizing Returns on State Investments,* Proceedings of the Conference on Financing State Government, Bozeman, Montana, (1960), p. 125.

[20] National Municipal League, *Model Investment of State Funds Law,* (1954), pp. xiv and xv of Introduction.

Close liaison between the investment agency and the agencies holding the funds, however, must be established. Periodic consultation on actuarial and liquidity problems and other long range policy matters will be necessary, as will frequent communications regarding cash balances. One reason for limiting two of the governor's appointments to nominees of the major retirement systems is to insure representation of the interests of the systems and good coordination of investment policies.

In order to insure an orderly transition of the investments programs and to afford the investments officer an opportunity to set up his office and hire key personnel, an effective date of January 1, 1966 is suggested. However, the first four sections of the bill providing for the appointment of the investment council would be effective July 1, 1965. This would give the investments council enough time to search out and employ a qualified investments officer several months before the new agency assumed responsibility for the investments program.

The Council estimates the annual expense of maintaining the central agency as follows:

Salaries	
Investments officer	$20,000
Assistant	9,000
Secretary	5,000
Typist-bookkeeper	4,500
Operation and Expenses	11,500
TOTAL	$50,000

It is somewhat unfortunate that a separate agency must be created to administer investments, but this is the price Montanans must pay for an overly specialized, fragmented governmental structure. There is simply no logical place in our present governmental framework to fit this function.

The Council pointed out in 1962, "The State Treasurer, as custodian of state funds, is the logical person to assume responsibility for the investment of state money. Yet as long as the Treasurer is elected, chances of a qualified [investments] person entering office are remote."[21] Aside from the slight amount of time now spent by the State Treasurer in investments work, the remaining duties of the job are all clerical in nature and could be undertaken by an investments officer as a relatively routine sideline. It was in anticipation of the need for a consolidated investment agency that the Council recommended two years ago that the constitutional status of the State Treasurer be eliminated "to enable the legislature to provide for a qualified appointive official to assume responsibility for operating the state treasury and supervising investments."[22]

In evaluating the consequences of creating a new state agency, legislators should distinguish between service and control agencies. A great majority of state agencies were established to serve a certain clientele or segment of the population, and were often created through pressure from special interest groups. On the other hand, the creation of control agencies is not likely to be enthusiastically supported by constitutents who are not knowledgeable about the intricacies of government. Yet it is this latter group that can provide the economies so badly needed in government.

---

[21] Montana Legislative Council, *Executive Reorganization*, Report No. 7, (1962), p. 35.
[22] *Ibid.*, p. 36.

> ***Agencies responsible for financial and general administrative functions do not, as a general rule, offer services to the public; they do not build highways, educate youth, or provide welfare or health services. Yet it is the activities in this area of government that unify and validate all direct services provided by state government for its citizens. The manner in which governmnetal purchasing, budgeting, accounting and planning are performed directly affects the efficiency of all programs of state government.***[23]

The Investment Council will be a revenue producing agency. Immediate increased revenue of more than $200,000 annually can be expected as a result of proper investment of treasury cash. If recommendations for broadening permissible investment media are adopted, benefits to the taxpayers of the state and beneficiaries of the funds could amount to millions of dollars annually.

Sections 12 through 15 of the proposed bill reenact the present laws governing the types of investments for the various funds. The recently revised treasury fund structure, as anticipated, will facilitate investment because accounts with similar characteristics have been grouped together. The only income earning funds under this law will be the trust and legacy fund, agency fund, sinking fund, bond proceeds and insurance clearance fund, and general fund.

In the case of the trust and legacy fund and the agency fund, the state is in the position of a trustee or agent and does not, in the legal sense, own the money. The funds were created for the purpose of earning interest income.

Moneys in the sinking fund and bond proceeds and insurance clearance fund are dedicated to defray the costs of specific projects. Under the proposed law the interest income obtained from investing the proceeds from the sale of bonds, as well as from investing a sinking fund may be used only for debt retirement. This will prohibit the use of interest income on moneys obtained from the sale of bonds for the purpose of increasing expenditures.

All other moneys would be invested as surplus cash for the benefit of the general fund. Under present law, an agency operating with moneys from a dedicated revenue source has the privilege of removing the money from the state treasury and investing it for its own benefit. Not more than a half dozen agencies are now engaged in this practice, and the interest income is not an important source of agency revenue. Agencies involved are the Fish and Game Department, the Highway Commission, the Livestock Commission, the Livestock Sanitary Board, the Board of Cosmetology and the Oil and Gas Conservation Commission. Splintering away small amounts of moneys from the treasury reduces the flexibility of the investment of surplus cash, increases the difficulty of predicting cash flow, and complicates bookkeeping. Moreover, the fact that the legislature earmarked a specific tax to finance a governmental program does not give the agency whose responsibility it is to administer that program the right to treat the money as its own prior to expenditure. Until the money is spent it is public money; the practice of tucking it away for the purpose of gaining a windfall in the form of interest income is not necessarily consistent with the goal of legislation dedicating the revenue.

The law currently permits the investment by the state of moneys in the custody of a city, county or school district on request of the local official. This provision is omitted in the proposed drafts. In the ten years since the law was enacted, the State Board of Land Commissioners has not received one request. Since then local units of government have been given increased investment authority, so the elimination of this provision will not prevent cities and counties from earning interest income. After the state investment agency has functioned for several years, it would be desirable to review the investment needs of local government to determine if the state agency could provide assistance, either in an advisory or investing capacity.

---

[23] Montana Legislative Council, *Executive Reorganization,* Report No. 7, (1962), p. 11.

Chapter II

RESTRICTIONS ON INVESTMENT MEDIA

Historical Development of Investment Policy

LAND GRANT FUNDS

Only two provisions governing the investment of public moneys were included in the Montana Constitution adopted in 1889. They are Sections 3 and 12 of Article XI.

> Section 3. Such public school fund shall forever remain inviolate, guaranteed by the state against loss or diversion, to be invested, so far as possible, in public securities within the state, including school district bonds issued for the erection of school buildings, under the restrictions to be provided by law.
>
> Section 12. The funds of the state university and of all other state institutions of learning, from whatever source accruing, shall forever remain inviolate and sacred to the purpose for which they were dedicated. The various funds shall be respectively invested under such regulations as may be described by law, and shall be guaranteed by the state against loss or diversion. The interest of said invested funds, together with the rents from leased lands or properties shall be devoted to the maintenance and perpetuation of these respective institutions.

The statement in Section 3 regarding the nature of investments is apparently only advisory. Thus, the original constitution imposed no restrictions on the investment of public lands proceeds; this matter was left to the legislative assembly.

By 1895 the legislature had implemented the constitution by providing that the proceeds derived from the sale of lands granted to the state for educational purposes could be invested in (1) bonds of the state of Montana, (2) bonds of the several counties of the state, (3) bonds of school districts within the state, and (4) bonds of the United States or in first-class state bonds.[1]

Alhough some minor changes were made during the next two decades, the first major revision of the investment laws occurred in 1917 when the "Farm Loan Law" was enacted. This law expanded the permissible types of investments to (1) bonds of school districts within the state, (2) bonds of the state of Montana or the United States, (3) interest bearing warrants upon the general fund of the state, (4) state capitol building bonds of the state, (5) bonds of irrigation districts within the state, (6) first mortgages on good improved farm land in the state, (7) first mortgage farm loan savings bonds, (8) bonds issued by federal farm loan banks, and (9) in bonds of the several counties and cities of the state.[2]

Within a few years of its passage it was apparent that the Farm Loan Act had proven unsatisfactory and would probably result in some losses to the state. Nevertheless, State Land Commissioner I. M. Brandjord expressed his conviction that the trust funds should continue to be invested in farm real estate. He partially attributed the failure of the farm loan program to defects in administration and the law, which he proposed to correct.

Thus, Article XXI of the constitution, which was adopted in 1924, permitted the investment of the trust and legacy fund (which at that time did not include the public school fund) in loans secured by mortgages on town and city homes, as well as farms. Apparently, how-

[1] Section 3508, Codes and Statutes of Montana, 1895.
[2] Chapter 124, Laws of 1917.

ever, the main purpose of this article was to provide machinery for the acceptance of gifts and donations to the state and to provide a unified system for investing all permanent funds.

In 1934 Commissioner Brandjord reported that the unified investment plan had been tested out, and should be extended to include all permanent funds arising from land grants to the state. The legislature in 1937 approved an amendment which was adopted by the people in 1938. The amendment incorporated Commissioner Brandjord's recommendation to consolidate the public school funds with other permanent funds for investment purposes, but at the same time injected the following detailed provisions on permissible types of investments.

> Section 8. The Montana trust and legacy fund shall be safely and conservatively invested in public securities within the state, as far as possible, including school district, county and municipal bonds, and bonds of the state of Montana; but it may also be partly invested in bonds of the United States, bonds fully guaranteed by the United States as to principal and interest, and federal land bank bonds. All investments shall be limited to safe loan investments bearing a fixed rate of interest . . .

OTHER FUNDS

When the Teachers Retirement System was established in 1915 the governing board was given power to invest in "any securities legally designated for investment in public school fund."[3] When the Trust and Legacy Fund was created the board was given power to invest all funds "as part of the trust and legacy fund."[4]

The Public Employees Retirement Fund was originally invested under the "same limitations and restrictions that apply to savings banks."[5] When the unified investments plan was fully implemented in 1953 the permissible types of investments for both retirement systems and the Industrial Accident Board were expanded to include, among other things, government insured mortgages. In 1961 authority to invest these funds in certain types of corporate bonds was granted.

Present Statutory Provisions

The unified investments plan sets up three different funds, each of which is subject to different restrictions as to permissible types of investments. Since the unified investment plan was never implemented, however, the investment funds it created never came into existence. The statutory language creating the funds operates simply as a restriction on the types of investments for the moneys which were supposed to comprise a particular fund.

(1) The first of these funds is the Montana Trust and Legacy Fund which consists of the permanent school fund described in Article XI of the constitution ". . . and all other public funds of the state subject to long-term investment not legally in the custody of any lawfully constituted board or the investment of which has not been designated by statute." The trust and legacy fund may be invested as follows:

a. Bonds of school districts within the state of Montana.
b. Bonds of the counties and cities of the state of Montana.
c. Bonds of the state of Montana.
d. Bonds of the United States.
e. Capitol building bonds of the state of Montana.
f. Federal land bank bonds.
g. Interest bearing warrants upon the general fund of the state.
h. Interest bearing warrants upon the general fund, the poor fund, the road fund, or the bridge fund, of the several counties of the state.

[3] Chapter 94, Laws of 1915.
[4] Chapter 87, Laws of 1937.
[5] Chapter 212, Laws of 1945.

(2) The second fund is the Long Term Investment Fund. The State Board of Land Commissioners is authorized to invest in this fund highway patrolmen's retirement moneys in excess of $25,000, the public employees retirement fund, the industrial accident reserve fund, all funds subject to investment as designated by the teachers retirement board, that part of the fish and game fund which is available for investment, "and all other funds designated by statute." Money in the long term investment fund may be invested as follows:

a. Securities which are direct obligations of the United States government; securities which are guaranteed as to principal and interest by the United States government; securities issued by instrumentalities of the United States government.

b. General obligation bonds of school districts within the state of Montana; in general obligation bonds of the several counties and cities of the state of Montana; in general obligation bonds of the state of Montana; in capitol building bonds of the state of Montana; in bonds issued by the federal land banks; in bonds issued to construct buildings for state agencies or institutions; in interest-bearing warrants upon the general fund of the state and in interest-bearing warrants upon the general fund, the poor fund, the road fund, the retirement fund, or upon the bridge fund of the several counties and school districts of the state of Montana.

c. Obligations or stock of the following agencies of the government of the United States of America:

   1. Commodity credit corporation.
   2. Federal intermediate credit banks.
   3. Federal land banks.
   4. Central bank for co-operatives.
   5. Federal home loan banks, and stock thereof.
   6. Federal national mortgage association, and stock acquired in connection with sale of mortgage loans to the association.

d. First mortgages on unencumbered real property which are guaranteed or insured in the amount of fifty per cent or more of the loan made in the event of default by the United States government or any agency of the United States government, and in obligations of housing authorities. No more than fifty per cent of the funds in one account may be invested in such mortgages.

e. First mortgage bonds, debentures, notes and other evidences of indebtedness issued, assumed or guaranteed by any solvent and operating public utility corporation existing under the laws of the United States of America or any state which are, at the time of such investment, within the three (3) highest quality grades for the rating of such bonds, debentures, notes and other evidences of indebtedness by any nationally recognized investment rating agency.

f. Equipment trust obligations or certificates adequately secured and evidencing an interest in transportation equipment, wholly or in part within the United States of America, which carry the right to receive determined portions of rental, purchase, or other fixed obligatory payments to be made for the use or purchase of such transportation equipment, and which are, at the time of investment, within the three (3) highest quality grades for the rating of such obligations or certificates by any nationally recognized investment rating agency.

(3) The third fund is the Short Term Investment Fund. The State Board of Land Commissioners is to invest under this fund any surplus cash in the office of the State Treasurer; any money in the sinking fund not required for the immediate payment of bonds, prin-

cipal, or interest; any Montana highway patrolmen's retirement moneys less than $25,000; and any other fund designated by statute to be so invested or any fund in the custody of an officer of the state or of any city, county, or school district if the investment of the fund is requested by the officer or governing body. Moneys in the short term investment fund may be invested as follows:

1. Surplus cash in the treasurer's office may be invested in registered warrants of the state and in treasury obligations of the United States government.
2. Any sinking fund and any other moneys may be invested in the bonds of the state of Montana or bonds of the United States, treasury obligations of the United States and in interest bearing warrants upon the general fund of the state.

On July 1, 1964, the status of the funds of the four major investing agencies was as follows:

Status of Funds of Four Major Investing Agencies—July 1, 1964

	Trust and Legacy	Teachers Retirement	Public Employees Retirement	Industrial Accident
U. S. Treasury Obligations*	$36,252,000 (76.12%)	$ 7,601,000 (25.34%)	$ 9,237,890 (27.05%)	$10,271,350 (88.80%)
Municipal Bonds	9,974,022 (20.95%)	1,271,000 (4.24%)	0	0
State Bonds**	850,000 (1.78%)	0	0	450,000 (3.89%)
FHA and VA mortgage Loans	Not permitted	14,111,000 (47.04%)	16,140,153 (47.27%)	362,281 (3.13%)
Public Utility Obligations***	Not permitted	6,710,000 (22.37%)	8,131,376 (23.81%)	0
Registered Warrants	0	380	528	0
Cash	547,812 (1.15%)	303,000 (1.01%)	640,085 (1.87%)	483,848 (4.18%)
TOTAL	$47,623,834 (100.00%)	$29,996,380 (100.00%)	$34,150,032 (100.00%)	$11,567,479 (100.00%)

*Includes U. S. Treasury obligations, Federal Land Bank Bonds, F.H.A. mortgage debentures.

**Includes Capitol Building Bonds.

***Includes Public Utility Bonds and Railroad Equipment Trust Certificates.

The Nature of the Funds

The four major funds susceptible to long term investment have, to a greater or lesser degree, common characteristics, the most outstanding of which are minimum liquidity requirements.

Nearly all of the trust and legacy fund is derived from federal land grants. The fund will never be diminished, but will continue to grow as receipts from the sale of state lands, timber, and mineral royalties, as well as a portion of the income, are added to it.

Contributions and earnings paid into the two retirement funds will exceed disbursements by a substantial margin for the next generation. Although individual employees come and go, there is no prospect that accumulated pension funds will ever be liquidated. Furthermore, these funds are not subject to catastrophic hazards or other sudden unforeseen developments. People do not grow old all of a sudden. Retirements and pension payments can be forecast with reasonable accuracy many years in advance.

As an insurance reserve the industrial accident fund is subject to catastrophic hazards, but not to the extent of a commercial insurance company. Payments to beneficiaries for death or total disability claims are almost always spread out over a 500-week period. In the event of an industrial catastrophe involving the death or injury of a great number of workmen, no sudden, substantial drop in the fund balance would occur, but increased payments over a decade would be scheduled.

Thus, the long term liabilities of these funds permit long range investment objectives. Short run performance and temporary market conditions are not controlling; it is the performance over the infinite life of the fund which is important.

Another common characteristic is the exemption from federal income and capital gains taxation; the investors of these funds need not consider this factor which is so important in other investment situations.

Major Investment Media Available for Long Term Investment

(1) U. S. Government Obligations: U. S. Treasury long-term bonds are the most popular investment media for public funds. They are an uncomplicated investment media and require little supervision. Statutory restrictions designed to maintain safety of principal are also partially responsible for the heavy investment in U. S. treasury obligations. During the early 1940's there was an ample supply of governments, while only small amounts of good corporate bonds were being offered. In the latter 1950's treasuries declined in relative importance in the investment of new money. The outstanding characteristics of treasuries are an unquestioned credit rating, marketability, and non-callability.

(2) Municipal and State Obligations: In general, the popularity of municipal securities is due to exemption from the federal income tax, and because they are generally accepted as "legals" for many institutional and trustee investments. Because of these features, which offer no advantages to public funds, most municipals of satisfactory grade yield a return which is lower than that of treasuries.

(3) Corporate Obligations: Corporate bonds are an attractive investment medium. A high level of security can be maintained and generally, they offer a higher yield than governments or municipals. Business depressions aside, there is a continuous supply of new issues offered each year. For 1958, the U. S. Securities & Exchange Commission reported that there were $9.6 billion of new corporate obligations sold in the United States.

Corporate bonds have long been an accepted investment media, from both a quality as well as an earnings point of view, for life insurance companies, commercial and savings banks and for private industrial pension funds. Corporate bonds come from three major sources: industrial companies, utilities and railroads.

(4) Real Estate Mortgage Loans: Real estate mortgages constitute a popular outlet for investments because of the safety of well secured loans, the comparative higher net yield and the large continuous supply for investment.

In addition to the security offered by the land mortgaged and the credit of the mortgagor, many home mortgages have the backing of the credit of the Federal Government, either in the form of an F.H.A. guarantee or V.A. insurance. Thus it is possible to obtain quality almost equivalent to that of U. S. Governments, but with a substantially higher yield.

Mortgages have a higher acquisition cost than bonds and require post-acquisition servicing costs. Nevertheless, it has been the experience of life insurance companies, savings and loan associations, savings and commercial banks that mortgages yield a substantial net differential over alternative fixed income obligations.

(5) Corporate Equities: With the growing industrialization of the nation, careful regulation of the securities markets, elevation of the mores of the market place, and improvement in economic and financial controls of the business cycle, common stocks have become an accepted part of the long-term public fund portfolio. Selected with care, and diversified as to industries and companies, the common stocks of private corporations are attractive to public and private retirement systems because of their greater overall return through cash dividends and capital appreciation.

Effect of Constitutional and Statutory Restrictions

TRUST AND LEGACY FUND

Long term fund growth is a combination of additions to principal and current yield on the total invested principal. The failure of a fund to experience capital growth as well as to produce a respectable current yield will necessitate increased reliance on appropriated funds to close the gap between income and obligations. Recognizing this problem, some states have modified the traditional approach to state funds investment.

Protection of principal, which is ostensibly present in Montana's investment programs, is of course, one of the important objectives of any investment program. However, safety of principal should not be allowed to negate other investment objectives — capital growth and the earning of interest income. The goal of an investment program should be the greatest possible interest income without sacrificing safety or liquidity. The Montana trust and legacy fund consists entirely of U. S. and local government securities. The cost of such "super safety" is paid in terms of reduced rates of interest income and lack of capital appreciation.

And it is not really true that investment in government securities always protects principal. At a hearing before a California legislative committee, one witness pointed out that "The old U. S. Victory Bonds were selling for $86 in 1961 or 1962. In 1946 they sold for $106 and that is just exactly sixteen years ago. In the intervening time you have lost 20 points of principal which represents 8 years of interest at 2½% a year. So, certainly, change in interest rates can be very costly in investment if you don't protect yourself against it."[6]

If government securities are held until maturity, they can be retired at par, but even then the principal will have diminished in purchasing power. The effect of inflation on funds invested exclusively in fixed income securities is known to everyone. A security which cannot show capital appreciation cannot really preserve the principal because the principal only has meaning in terms of the goods and services that can be purchased with it. Inflation can diminish the principal just as a bad investment can.

[6] Testimony of Mr. Robert S. Driscoll, Senior Partner of Lord-Abbot & Co. of New York, *Final Report of the Joint Interim Committee on the Investment of Public Retirement and Pension Funds,* Assembly, California Legislature, (1962), p. 13.

Chart 1 shows the degrading effect of inflation on Montana's common school fund. During the period from 1929 to 1959, primarily as a result of sales of state lands, timber, and mineral royalties, the fund grew from 13 million dollars to 38 million dollars — an increase of 192%. During the same period the annual interest income from the fund in constant dollars (adjusted to reflect loss of purchasing power) fell from $1,400,000 to $1,000,000—a decrease of 28%. In other words, Montana is sacrificing interest income but is not attaining safety of principal in terms of purchasing power.

A select group of bankers and investment men appointed by the Governor of Minnesota to review investment of state trust funds reported:

> ***In the management of the state trust fund the paramount consideration must continue to be safety and preservation of principal just as it has been in past years. Nevertheless the experience extending over many years of other funds of a similar fiduciary character and purpose demonstrates conclusively that principal can be maintained safely while still obtaining a yield of at least 1.25% above the yields now being obtained on the state trust funds. Applying such a yield differential to total funds of $302 million it is apparent that the people of Minnesota have been losing at least $3,750,000 annually in potential revenue.***[7]

At the time of this report the portfolio of Minnesota's trust funds closely resembled Montana's trust and legacy fund, and the yields of the two funds were substantially the same. If the findings of this committee apply to the Montana trust and legacy fund, as they seem to do, the yield on the fund could safely be increased by 1.25%, with an increase in annual income for the schools of more than one-half million dollars.

A former New Mexico State Investment Officer, who participated in the diversification of the permanent fund of that state, wrote:

> ***Failure to offset the continued shrinkage of the value of the nation's monetary unit through compensating investment measures in the management of the Permanent Funds will impose an ever-increasing burden on the taxpayers of the State, for the mounting loss of real income received by the beneficiary institutions from their invested endowment will require an offsetting increase in legislative appropriations for institutional maintenance. The hazards of an aggressive program of investment in growth equities are no greater, it should be recognized, than the predictable loss that will be incurred through failure . . . to adopt adequate counterinflationary measures in its long-range investment planning.***[8]

"Capital is subject to two main risks: inability of creditors to repay loans and depreciations through inflationary price changes. The first risk can be eliminated by making no loans and earning no income. The second risk requires determining which kind of assets will best maintain purchasing power—land, cash, bonds, equities, securities, buildings, etc."[9]

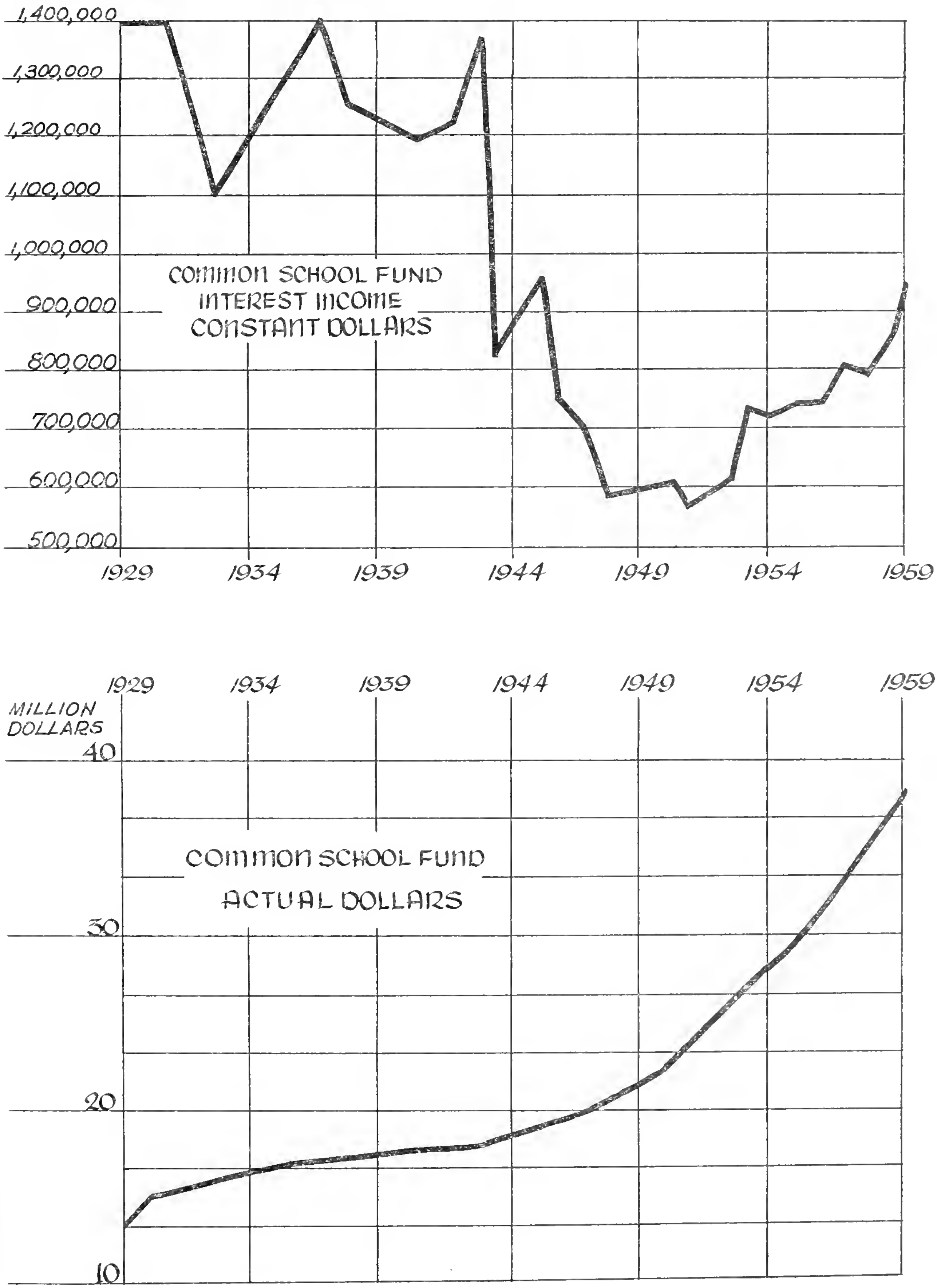
There is general agreement among professional investors that detailed and restrictive constitutional provision retard an effective investments program. The Minnesota committee reported:

> ***Circumstances prevailing at the time of the drafting of these constitutional provisions are no longer present today. Now there are greater needs for revenue due to increased cost of public services, education being one striking example. For the trust funds to meet the demands of the present it is apparent that a more adequate rate of return becomes important along with preserving the principal. The objective, therefore, becomes one of striving for higher income with fully adequate degree of safety. These are not opposites and a workable solution is readily attainable.***[10]

---

[7] *Report of the Minnesota Committee on Investment of State Trust* Funds (1960), p. 8.
[8] Edmund H. Kase, Jr., "The New Mexico State Investment Council—Five Years in Retrospect," *New Mexico Business* (August 1964), p. 7.
[9] Oregon Legislative Fiscal Committee, *Investment Management*, (1962), p. 13.
[10] *Report of the Minnesota Committee on Investment of State Trust* Funds (1960), p. 1.

CHART 1.—EFFECT OF INFLATION ON COMMON SCHOOL FUND INTEREST INCOME.



PENSION AND INSURANCE RESERVE FUNDS

The same general problem exists for pension funds and insurance reserve funds.

> ***Retirement system investment management has a single objective: to provide the highest possible level of net earnings over a long period of years. The obligation of the trustees is to seek every practical means of achieving this goal. While it is desirable that the soundness of the system never be called in question this does not mean that the trustees should be hypersensitive to uninformed criticism or second guessing by experts in the use of hindsight. The prudent man rule, the traditional and tested standard of trusteeship, recognizes that 'do what you will, the capital is at hazard.' Acceptance of risks for commensurate returns is the business of investment.***[11]

Investment of pension funds is not, as one might think, an incidental means of augmenting income from employee and employer contributions. Investments are an integral and crucially important part of any retirement system. "It should be borne in mind that an additional one-half of one percent of earnings over a 3% interest assumption will have the effect of reducing ultimate costs or of increasing pension benefits by 10% to 12%. Therefore, it can be seen that this matter of investment income is very important."[12]

A study of investment management for the state of Oregon reported that

> ***Increased earnings from investments of the retirement system and the industrial accident commission are extremely important to the two programs. A 1% increase in yield for the Oregon public employees retirement system will produce a 27% increase in benefits or 21% reduction in cost during a thirty year contributing period and a 15 year payout period. A 1% increase in earnings for the industrial accident commission in 1962-63 will produce over $700,000 and reduce employer contributions in that year by this amount.***[13]

Protection against inflation is probably even more important with retirement systems than with the trust and legacy fund. The retirement systems have, in effect, contracted to pay out a specified number of dollars upon the retirement of a member. However, the member is contributing 1960 dollars and will be paid back in 1980 or 1990 dollars, which, if the inflationary trend continues, will be worth 50c or 75c in terms of today's purchasing power. "Public pension programs have the objective if not an obligation to provide payments commensurate with living costs at time of retirement."[14]

Although they are not as permanent as constitutional restrictions, statutes listing in detail permissive types of investments may inhibit effective fund management. "It has been said that 'legal lists' represent the crystalized experience of an earlier generation. Consequently they are not merely out of step with current conditions but fail completely to anticipate the future."[15]

---

[11] Roger F. Murray, *Report to the Ohio Legislative Commission on the Retirement Systems of the State of Ohio,* (1962), p. 2.

[12] Gardner and Lindberg, *Policies and Practices of Industrial Retirement Systems Investments* (1961), p. 10.

[13] Oregon Legislative Fiscal Committee, *Investment Management* (1962), p. 56.

[14] Moody's Investors Service, *Policy Investment for the Funds of the California State Employees Retirement System* (1960), p. 15.

[15] Moody's Investors Service, *Policy Investment for the Funds of the California State Employees Retirement System* (1960), p. 25.

Ironically, corporate pension funds and private educational institutions have long operated free of the onerous restrictions imposed by the states upon their own funds. Charts 2 and 3 show the dramatic increase in investment in corporate securities in these areas. The same is true of trusts maintained for the benefit of surviving widows, orphans and others.

> ***Thus a situation exists where many fiduciary institutions that operate under state supervision and control, and that serve aims analagous to those of state trust funds, enjoy much more liberal provisions with respect to their investment powers than do the state's own funds. It is at least arguable that the protection afforded by the laws of the state to savings bank depositors, life insurance policy holders, and trust beneficiaries should not be less vigilant than that afforded those who benefit from the revenues of state-owned funds.***[16]
>
> ***It is possible that there are valid reasons for state trust funds to adhere to a doctrine that is largely abandoned by other sectors of the financial world. This position if held at all must be held by a small and rather silent minority as it is difficult to find expression of it in the pertinent literature. It may be that there was no pressure group in the case of state funds interested vitally in changing the existing restrictions. It is also possible that state officials were reluctant to add political risks to those inherent in any uprooting of the status quo.***[17]

Municipal and School District Bonds as an Investment for Public Funds

In the autumn of 1963, at the request of the Council, Moody's Investors Service analyzed the investment portfolios of the four major investing agencies. Insofar as municipal and school district bonds are concerned, the report stated:

> ***We do not favor investment of the moneys of these several funds in such obligations. From purely the investment point of view and as that reflects to the benefit of the membership deposits in these systems, municipal bonds are not comparative with general market obligations issued by the national government and corporations. Municipal bonds being exempt appeal to those having a federal tax liability and hence offer lower yields by reason of this fact. It is our understanding that these long term investment funds are not subject to income taxation and therefore the tax exempt feature has no attraction. To repeat, from a purely investment point of view municipal obligations are not attractive to these funds.***

In the past two years the two retirement systems have disposed of most municipal holdings. However, it has been the practice of the Department of Lands and Investments to submit a standard bit approximately equal to the rate on U. S. Treasury Bonds on all municipal and school district issues. This practice resulted in a fairly active buying program until recently when the relatively high rate of interest available on U. S. bonds effectively closed out municipal and school district bonds.

---

[16] Alek A. Rozental, *Investment Policy of Minnesota Trust Funds*, School of Business Administration, University of Minnesota (1956), p. 24.

[17] *Ibid*, p. 25.

CHART 2

ASSETS OF CORPORATE PENSION FUNDS

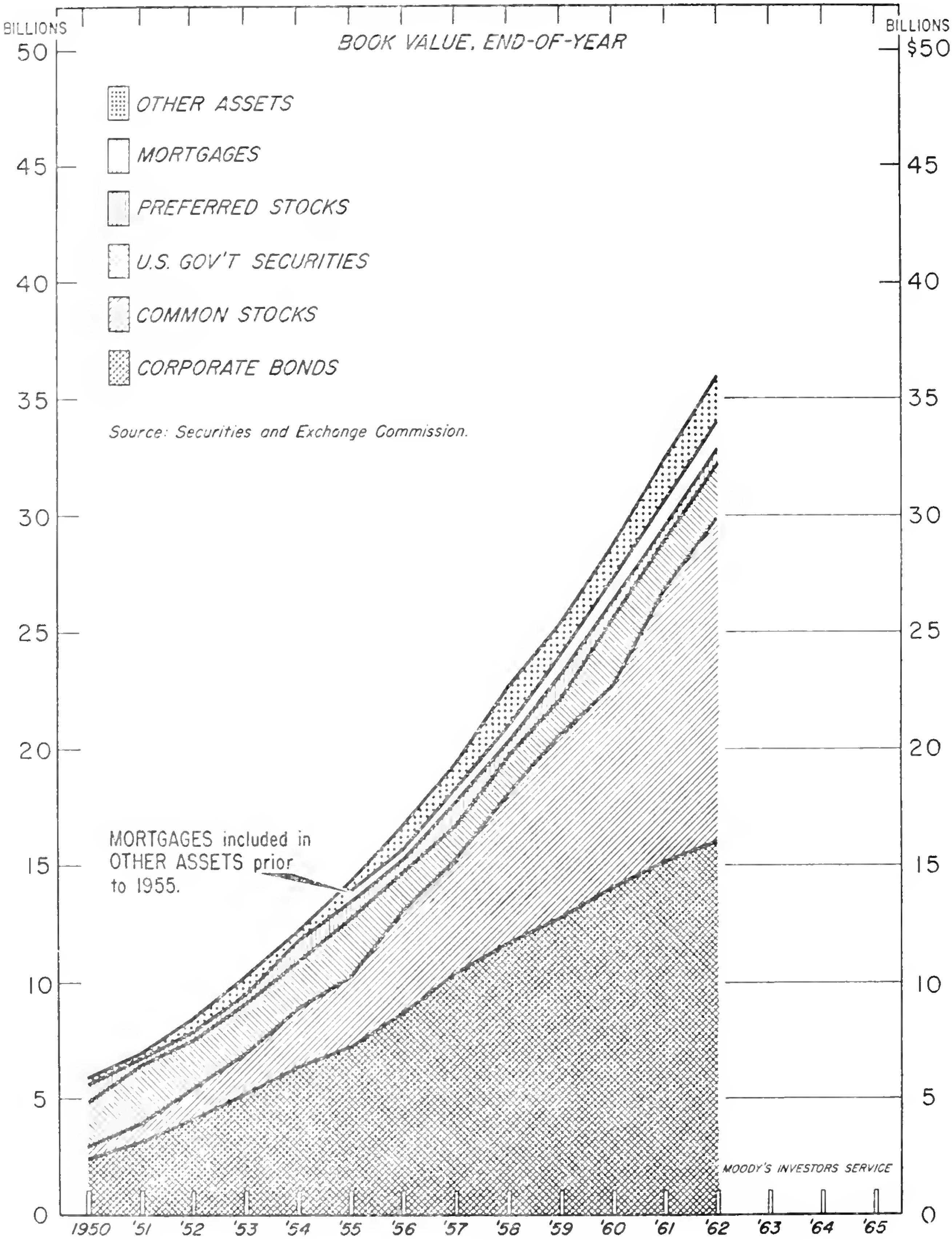
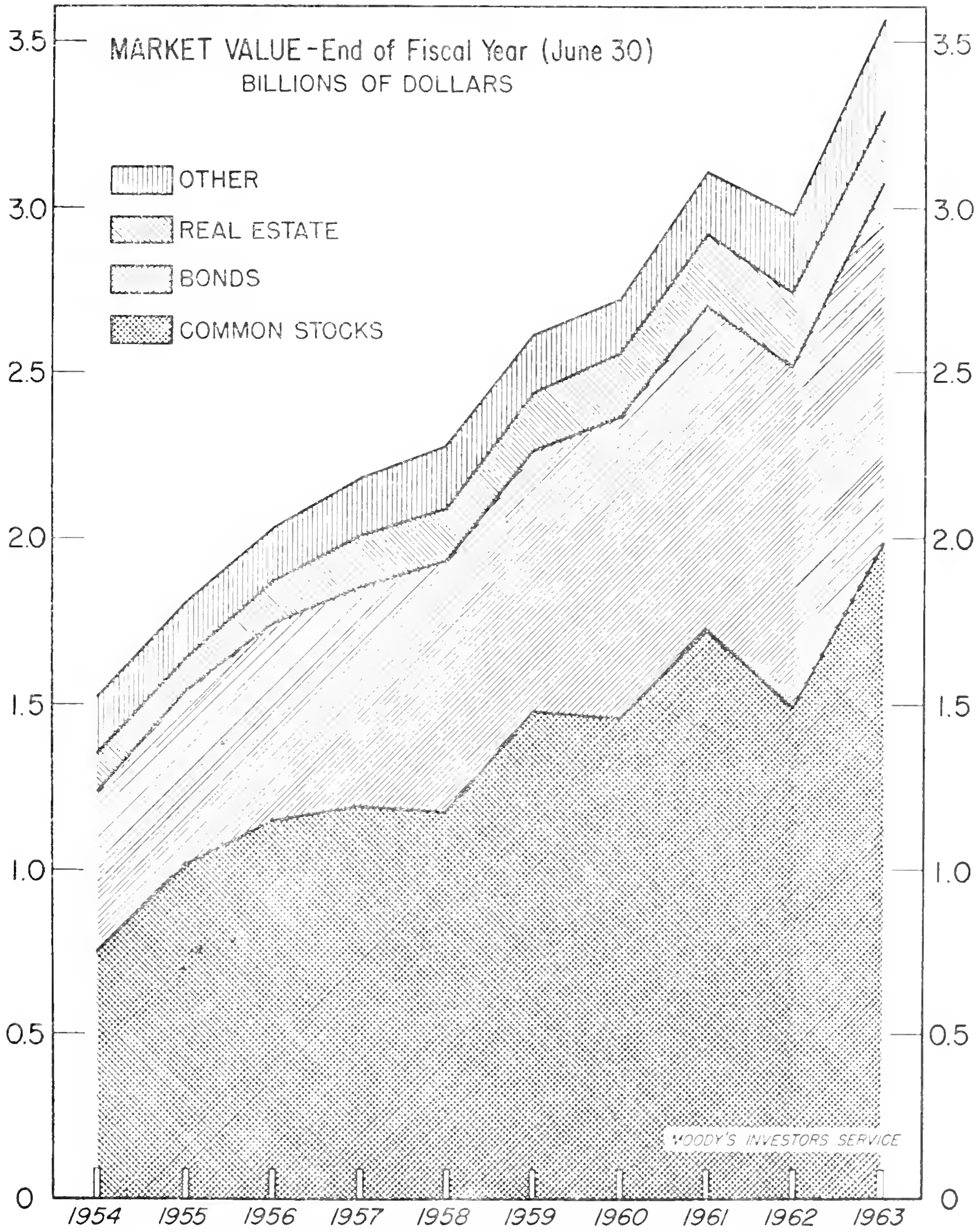


CHART 3

Summary of 30 College Endowment Funds



A recent report from North Dakota concluded that "municipal holdings involve assumption of extra risk with no increase in earning power," but added

> ***The owning of municipals, however, has been defended from another point of view. It is argued that state purchase of these securities helps to support their market and hence it is to the general benefit of the state of North Dakota. . . However it must be strongly emphasized that all state trust funds are not intended to directly benefit all North Dakotans. Instead some of them are special purpose funds sustained by the contributions of specific groups of citizens, and directed toward providing specific benefits for those same groups of citizens. For example, the teachers insurance and retirement fund is specifically established to provide a degree of financial security in the life of a teacher and not to uphold the general structure of municipal finance throughout the state.***[18]

Whether the purchase of municipal and school district securities actually "supports the market" is doubtful. In 1960 the Montana Legislative Council questioned the wisdom and the necessity of this practice.

> ***The state should examine its policy carefully of preferring local municipal and school district bonds over government bonds, particularly if the latter are consistently available at a higher rate of interest. Article XI, section 3 of the constitution provides that the school fund shall be invested "so far as possible in public securities within the state, including school district bonds issued for the erection of school buildings, under the restrictions to be provided by law." The provision of the constitution is, of course, only advisory. It was apparently the intention of the framers of the constitution to insure a market for school district bonds, particularly those issues so small as to be unattractive to large investment firms. This certainly is a laudable purpose. However, it may be that it is unnecessary for the state to bid on such bonds to insure a market. Furthermore, the purpose of the school fund is not only for those districts which are contemplating the financing of school buildings but for all schools of the state as well as the various units of the university system who can realize no special direct or indirect financial benefit from use of their funds for the purchase of school district bonds.***[19]

The fact that the Public Employees Retirement System and Teachers Retirement Board sold over $9 million of municipal and school district bonds in a period of less than a year and realized a profit on the sale indicates that a ready market exists.

Shortly after the creation of a centralized investments agency in Minnesota, the Executive Secretary stated that the agency believed that "over a period of time, the elimination of the state as a major factor in the local municipal bond market will result in a more orderly marketing procedure and in increased buying interest in Minnesota municipal securities throughout the nation."[20] Two years later the Executive Secretary reported

> ***Prior to April, 1960, it was the general policy of the state board of investment to purchase municipal bonds when they were offered at a yield exceeding that of comparable issues of U. S. government securities. Many of these municipalities and school districts, which formerly depended on the retirement funds to purchase a large portion of the debt securities, have, during the past three years, placed issues at interest rates substantially lower than the current yields from U. S. treasury obligations. Although we realize that many factors have contributed***

---

[18] Glen Allen Mumey and Gilbert W. Gimbel, *An Analysis of the North Dakota State Trust Funds,* Bureau of Economic & Business Research, University of North Dakota, (1960) pp. 16-17.
[19] Montana Legislative Council, *State Lands and Investments,* Report No. 4 (1960), p. 57.
[20] State of Minnesota Board of Investment, *1960 Report of the Executive Secretary,* p. 3.

to this phenomenon, we believe that the elimination of the state as a major participant in the segment of the local municipal bond market has resulted in a more orderly marketing procedure and an increased buying interest in Minnesota municipal securities throughout the nation. It is proper that these securities be purchased by individuals and institutions best able to use the tax exempt feature such securities afford. The fostering of such a market has helped to lower the interest costs for various school districts and municipalities, and, in that way, lower the tax burden of the citizens in these areas.[21]

The practice of the State Department of Lands and Investments bidding a rate on municipals equal to that of U. S. Treasuries is in itself open to serious question. Since the state gets no tax advantage it is obviously bidding a considerably lower interest rate than private investors feel is merited.

Generally there is a substantial risk associated with these municipal issues, which are so frequently the obligations of small entirely agricultural communities, and yet this portion of the portfolio is not producing yields greater than those which could have been obtained on risk free U. S. government securities. The reason for this unusual situation lies in the fact that income from municipal securities is not subject to federal income tax. Therefore, municipalities are able to borrow at a low rate of interest because persons and corporations in high tax brackets will buy securities in spite of this rate.

Since state funds do not pay income taxes, purchasing of municipals is not accompanied by tax advantages available to others. Therefore, a direct comparison of the municipal and U. S. government interest rates is justified. When this comparison is made it indicates that municipal holdings involve assumption of extra risk with no increase in earning power.[22]

In an objective appraisal of the practice of favoring local investments by Ohio retirement systems, Dr. Roger F. Murray of the Graduate School of Business of Columbia University said:

On any grounds, it is undesirable to favor local investments by setting lower quality standards or by not authorizing out of state investments... The notion of aiding economic activity in Ohio by concentrating investments within the state is clearly inappropriate and could be considered a breach of trust.

If the retirement systems lend and invest below going market rates, they are obviously making improper investments. If they are simply investing along with others at prevailing rates (presumably the actual case) they are doing nothing more for economic activity in Ohio than other investors would not be willing to do if the retirement systems withdrew from local markets. If there is not a free flow of funds into loans and investments in Ohio by local and national financial institutions, the remedy is to improve the investment climate and to remove any barriers to out of state lenders and investors.[23]

What I cannot understand is why other investors, receiving a benefit from the tax exemption feature, do not regularly outbid the system for the bonds.

---

[21] State of Minnesota Board of Investment, *1962 Report of the Executive Secretary*, p. 5.

[22] Glen Allen Mumey and Gilbert W. Gimbel, *An Analysis of the North Dakota State Trust Funds*, Bureau of Business and Economic Research, University of North Dakota (1960), p. 9.

[23] Roger E. Murray, *Report to the Ohio Legislative Commission on the Retirement Systems of the State of Ohio*, (1962), p. 6.

The only possible explanations are (1) poor marketing of their securities by the municipalities, (2) inferior quality, or (3) acceptance of too low yields by the system. Whatever the explanation, the appropriateness of this financing is open to question. The most plausible explanation is the first, which suggests that the system is serving a useful function but that local financing practices should be improved to the point where the system will be priced out of the market.[24]

The Council is not suggesting that statutory authority to purchase municipals by any investing agency be rescinded. However, it appears that other investment media are more attractive to the funds at the present time, and that current conditions would justify eliminating municipals from the portfolios. If the trust and legacy fund is given authority to invest in other media, ridding the portfolio of municipals is an even more urgent and desirable goal. The trust and legacy fund presently holds $10 million of school district and municipal bonds at an average yield of 3.04%. Currently Grade AA corporate bonds are yielding slightly over 4.5%. If the trust and legacy fund were able to dispose of its municipal and school district bonds and invest the proceeds in high grade corporate obligations the annual interest income would immediately increase $150,000 with no increased risk.

Experience in other states indicates that if state funds withdrew from the municipal bond market, a more orderly marketing procedure and increased buying interest in Montana municipal securities would result in lower interest costs and a lower tax burden. In the event that some support proved to be necessary, the state could reenter the market.

Common Stocks as an Investment for Public Funds

Historically, of course, the traditional and classical approach to the problem of investing trust funds, both public and private was in the area of fixed income securities, that is, bonds, or mortagages or any other security which contained a definite promise to repay the principal at a certain time together with a fixed rate of interest. If there is one thing, however, that you can count on in the investment field, it is change.

The change in the traditional concept of investments for trust funds of all types occurred in the period associated with World War II and the monetary inflation which occurred in that period. Interest rates were artificially controlled when prices were constantly rising and it was then that many investors turned to the equity market as a means of increasing their present yields as well as protecting their principal from the declining purchasing power of the dollar.

The basic investment decision now confronting trustees of all private funds is not WHETHER TO GO INTO COMMON STOCKS but WHAT PERCENTAGE of a fund to commit to this investment medium.[25]

None of the funds which are the subject of this study may be invested in common stocks. Many persons, particularly those who recall the 1929 crash and the depression that followed, regard investment in common stock as "gambling" or at the very least, "speculative."

There have been, of course, many seemingly sound reasons for conservative construction of the state laws and constitutional provisions. These reasons reflect the general attitudes towards investments that have been prevalent during one period or another both in Montana and the other states. For example, the absence of corporate securities on the eligibility list can be regarded as an outgrowth of that period of financial history when the advantage was on the side of the security issuer, when

---

[24] *Ibid.*, p. 11.

[25] J. H. Dion, *Maximizing Returns on State Investments,* Proceedings of the Conference on Financing State Government, Bozeman, Montana, (1960), p. 122.

financial scandals were the order of the day and when the investor was at the mercy of the "insiders" who manipulated markets for their profits. With the passage of time, however, increased governmental supervision and control have profoundly changed American financial conditions so that now some case might be made for stating that any existing advantage is on the side of the investor.[26]

Failure to understand the reasons for individual losses in 1929 has resulted in much of the suspicion of common stocks. One report describes the things these people did to "get burnt":

1. Failed to diversify among issuers. They "plunged" on a single "hot tip."
2. Failed to diversify or scatter purchases over time.
3. Traded for short-term market swings.
4. Bought on low stock margins.
5. Wholesale distress selling at a low point. No diversification or dollar averaging of liquidation. Inability to wait.
6. Bought highly speculative stocks. They were deluded into thinking that they were investing.
7. Failed to pay reasonable prices for securities purchased.
8. Failed to investigate or analyze securities, or to retain professional counsel.[27]

Another reason for resistance to the purchase of common stocks by public funds is the failure to recognize the fundamental difference between individual and institutional investment. The disastrous results for some individuals should not condemn stocks as an investment media for large professionally managed retirement or permanent funds with completely different characteristics and needs.

There is a fundamental difference between the common stock investment by an individual and by an institution such as the state trust fund. A fiduciary fund buys or should buy common stocks primarily for income and need not sell them except when there is a pronounced decline in the quality of that stock. An individual on the other hand frequently purchases stocks when growing prosperity and rising prices induce him to enter the market. He sells when the change in his own economic circumstances makes it imperative to do so. Unfortunately this is usually the situation when losses will be realized, as there is a correlation between the prosperity of the individual and the level of prices in the stock market. A permanent trust fund is never faced with the necessity of selling its assets to cover marginal requirements or to buy groceries. Under these circumstances loss from common stock investments can come about only through the decline in the earning power of the corporation, the ownership in which is represented by the equity security. . . . A portfolio that includes stocks of dozens of corporations with stable records of earnings, potential for growth and proven managerial ability can withstand occasional failures, passing of dividends or income decline in some of the corporations at any given period of time. Over a long period and provided that the stocks were of high investment quality to start with, the risk of holding equities becomes an actuarial one and one that can be borne with equanimity by a fund that is interested in the aggregate income performance rather than in the vagaries of the market place.[28]

---

[26] Montana Legislative Council, *State Lands and Investments*, Report No. 4, (1960), pp. 51-52.

[27] Moody's Investors Service, *Policy Investment for the Funds of the California State Employees Retirement System* (1960), p. A-28.

[28] Alek A. Rozental, *Investment Policy of Minnesota Trust Funds*, School of Business Administration, University of Minnesota, (1956), pp. 37-39.

An exhaustive report of the investment policies of the Oregon Public Employees Retirement System and Industrial Accident Commission reached similar conclusions:

> *Investing retirement fund moneys in common stocks has the same objective as in other media, namely, to accumulate as large a sum as possible by the time of retirement with a reasonable degree of certainty. Because contributions are made periodically and regularly the retirement fund grows in size over a long period of years. Thus a good background is provided for the operation of the "dollar averaging" theory in the periodic purchase of common stocks. In applying this theory it is the aim of experienced investment managers to obtain better than average results by diversified selection of industries and common stocks within an industry. This is usually accomplished by placing regular amounts in stocks which appear to have attractive growth potential taking into consideration all factors including prices. Common stock prices are subject to cyclical swings but they are ideally suited for carefully selected diversified portfolios which can be continued indefinitely on a dollar averaging basis and can be carried at cost with no need to meet current valuation or liquidity requirements. . . Even if current cash dividends remain below bond yields for a time the growing dividends usually provide a yield on the cost of common stocks greater than those of fixed income securities. It is not the current cash yield in dividends but the overall return of cash dividends plus appreciation which is significant in common stocks. . . Stocks purchased at today's prices are less apt to produce the same results in the next ten years as in the past and many feel that the present is not the time to buy equities. This may be true for some types of accounts but for the long term "dollar averaging" retirement funds it should not be true. One can hardly imagine a more unfortunate time to get into the equity market than 1929 and the depression period which followed, but if a retirement fund dollar-averaged its investments for the past thirty-one years the results would have proven rewarding. Analysis of past market experience points to the fact that good selection is more important than perfect timing in purchasing common stocks. A true long term holder of equities can ride out storms and stresses, disregard intermediate market swings and ultimately receive his compensation in the form of substantial long term appreciation.*
>
> *. . . Stock prices are subject to cylical fluctuation but the long term trend of equity prices has been upward. Basic forces to continue this trend are in evidence: expenditures for technology are bringing increased productivity to the economy; consumer demands are broadening and increasing; population is expanding; and the inherent long term inflationary nature of the economy will continue as it has for over one hundred and fifty years of the U. S. economic history. In periods of adjustment the market finds a bottom, then an upward path is resumed.*[29]

This long term pattern was demonstrated by the results of a study of the period 1871-1938 by the Cowles Commission. During this 63 year period "a broad list of all of the traded industrial, rail and utility common stocks enjoyed an annual compound return of 6.8% in dividends and market appreciation. When the Cowles series is extended to 1961 the combined return exceeds 7.5%. Such historical surveys demonstrate that a well selected, dollar-cost-averaged, widely diversified and continuously supervised portfolio of common stocks produces a most significant differential in returns over that of a fixed income portfolio."[30]

(See Charts 4 and 5.)

---

[29] Oregon Legislative Fiscal Committee, *Investment Management*, (1962), pp. 25-26.

[30] *Ibid.*, Appendix pp. 4-5.

CHART 4

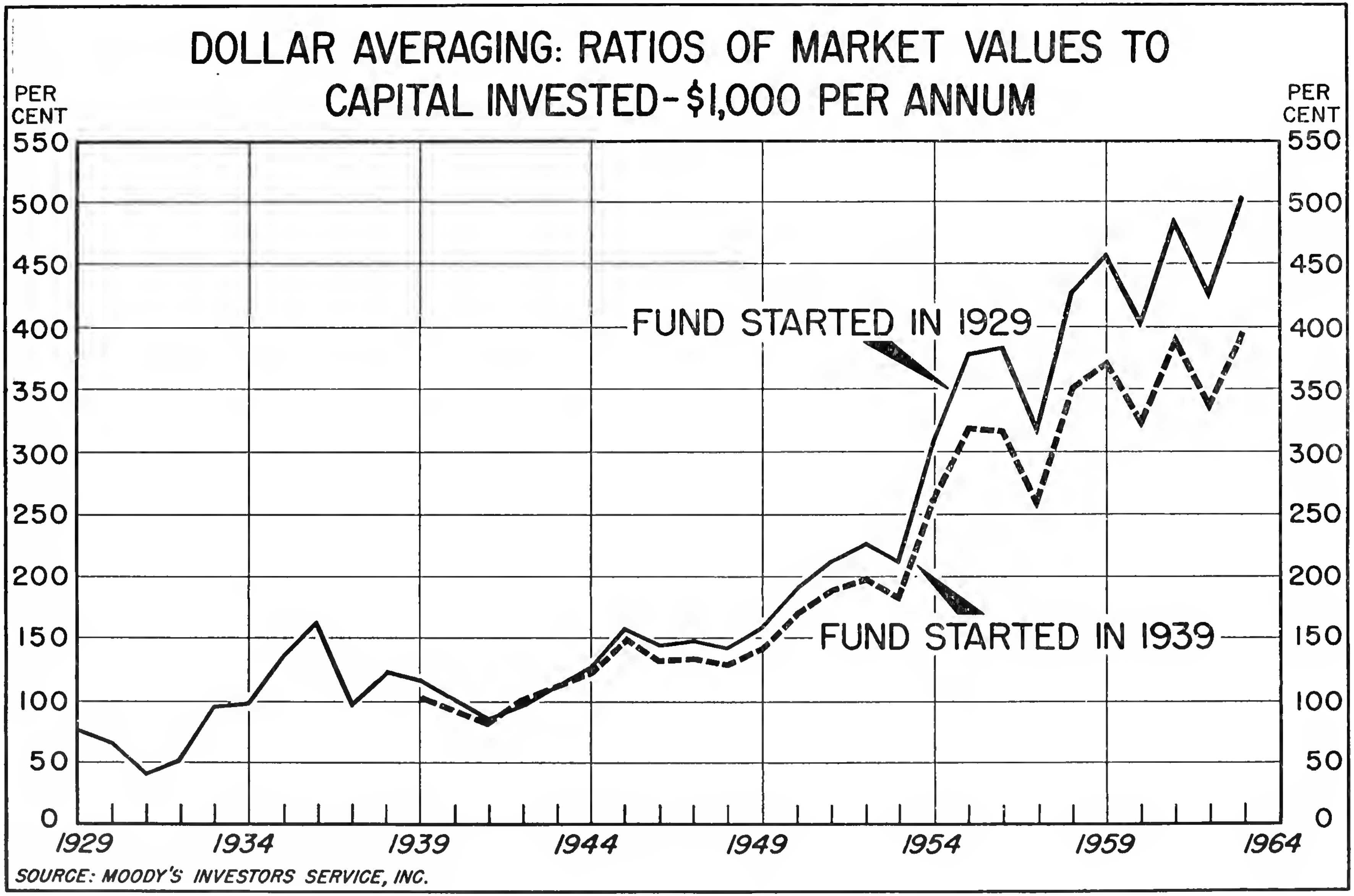
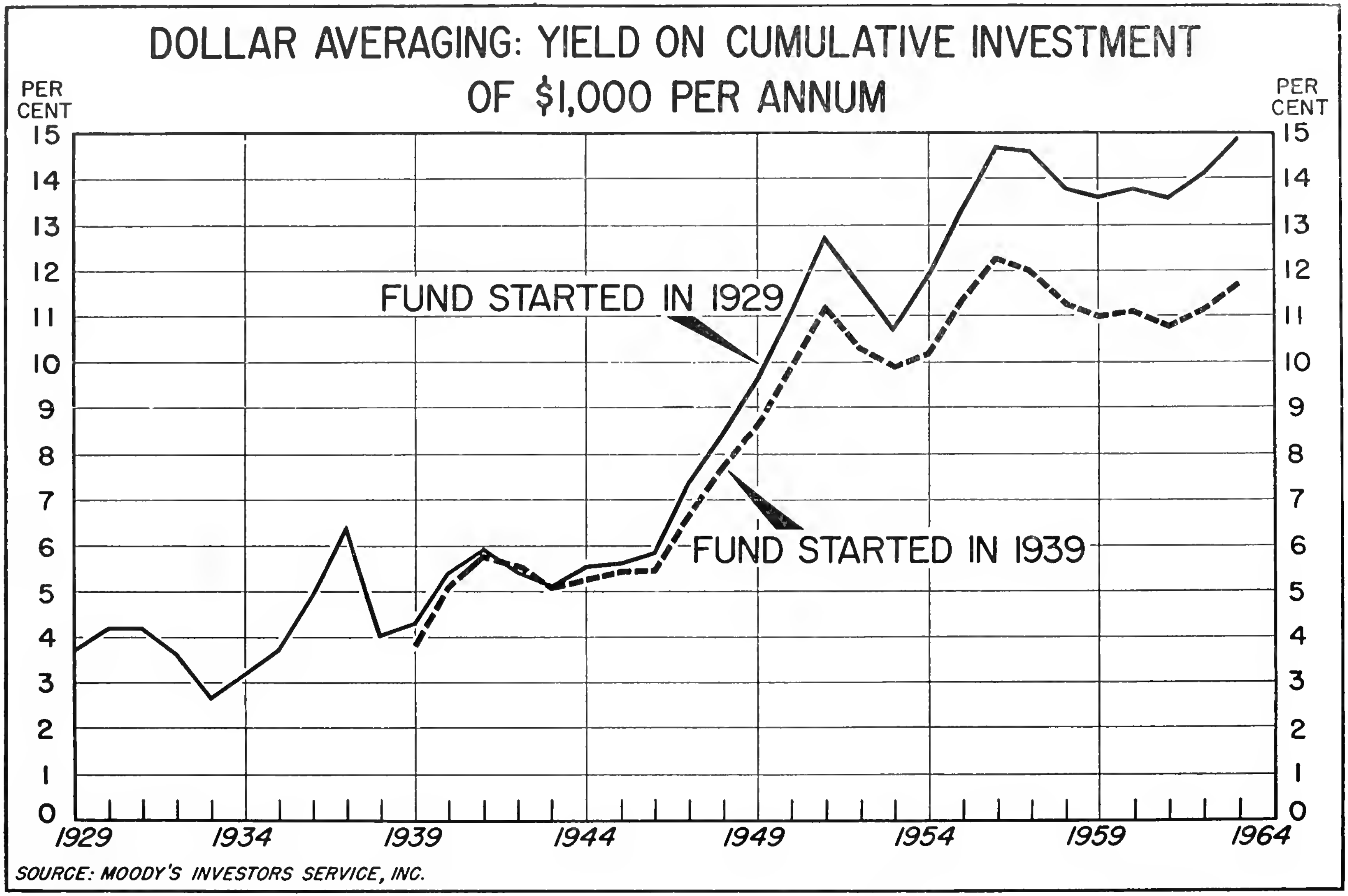

DOLLAR AVERAGING: RATIOS OF MARKET VALUES TO CAPITAL INVESTED-$1,000 PER ANNUM
PER CENT
550
500
450
400
350
300
250
200
150
100
50
0
FUND STARTED IN 1929
FUND STARTED IN 1939
1929
1934
1939
1944
1949
1954
1959
1964
SOURCE: MOODY'S INVESTORS SERVICE, INC.

CHART 5


DOLLAR AVERAGING: YIELD ON CUMULATIVE INVESTMENT
OF $1,000 PER ANNUM
PER CENT
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
1929
1934
1939
1944
1949
1954
1959
1964
FUND STARTED IN 1929
FUND STARTED IN 1939
SOURCE: MOODY'S INVESTORS SERVICE, INC.

Even more impressive are the findings of an exhaustive study recently completed by The Center for Research in Security Prices, of the Graduate School of Business, University of Chicago, under the sponsorship of Merrill Lynch, Pierce, Fenner & Smith Inc. This study presents the results of making an equal investment in each of the some 1,700 issues of common stock listed on the New York Stock Exchange for 1926 through 1960 at the beginning of each of 22 time periods of varying duration and subject to widely different market conditions. The findings demonstrate that common stocks held through booms and depressions, through war and peace, are far and away the most productive source of income, having provided rates (compounded annually) of return of greater than 10 percent for most of the periods covered by the study and of greater than 6 percent for two-thirds of the periods. The study was not confined to a selected list of "blue chips," but was applied to all companies having common stocks listed on the New York Stock Exchange.

The experience of one state which recently embarked on a common stock purchase program is interesting.

> ***The advisory committee recommended that a stock purchase program be stepped up during the period of lower market prices from June through October, 1962. Although the purchases made during the first year of our equity program were made at the all time high level of the stock market, the subsequent down turn resulted in attractive average costs for our commitments. Because of the 7.5 million dollars of stock purchases from May 22 through October 26, 1963, the common stock portfolio showed a market value somewhat above cost at year end, even though the Dow Jones industrial average at 652 was considerably below the 690-730 area prevalent during the entire first year of the purchase program. As of February 8, 1963 the common stocks showed a market value over cost of 1.4 million dollars or a net increase of approximately 6½%.***
>
> ***. . . We all realize that the securities in our accounts are subject to continual market fluctuations. The performance of our common stocks portfolio during the past year of extreme stock market changes has emphasized the advisability of purchasing equities on an average cost basis over a period of time. The state board of investments does not intend to use this as a trading account but, instead, intends to build a solid basis of investment in American industry, anticipating a gradual increase in income along with the growth of our economy. The stocks now owned were purchased at a yield of 3% during the past two years; this yield has already increased to 3.15% due to the dividend increases during this period.***[31]

Other states, notably Wisconsin, New Mexico and New Jersey, have reported similar success.

> ***In fact, one may assert that perhaps without exception the liberalization of state laws to entrust the investment administration of public trust funds to professional direction and to broaden the range of permissive investment media to include, inter alia, FHA-guaranteed mortgages, corporate bonds, and common stocks, has led to substantial improvement in the production of income from such funds.***[32]

---

[31] State of Minnesota Board of Investment, 1962, *Report of the Executive Secretary*, pp. 8 and 9.

[32] Edmund H. Kase, Jr., "The New Mexico State Investment Council—Five Years in Retrospect," *New Mexico Business* (Aug. 1964), p. 2.

Recent Developments in the Broadening of Investments in Other States

A digest of authorized and actual investments of state pension funds published by Investment Bankers Association of America in 1962 noted that between the years of 1959 and 1961 legislative authority authorized investment in corporate bonds in 9 additional state retirement systems and investment in preferred and common stock in 7 additional state retirement systems. By 1964, public pension funds in 28 states were invested partially in common stocks.

NORTH DAKOTA

The North Dakota Legislative Research Committee recommended a constitutional amendment which would provide that school funds could be invested "as the legislative assembly shall determine." The committee expressed the opinion that "the approval of such constitutional amendment and the subsequent investment of university and school land funds will result in a substantial increase in income available for the support of the common schools and institutions."

WASHINGTON

The Legislative Council conducted a study on investments and introduced a bill in the 1963 session which would permit the investment of the various retirement funds in common stocks.

OREGON

One of the recommendations of the Legislative Fiscal Committee after an exhaustive study of investment management was that investments in common stock be permitted by public funds.

SOUTH DAKOTA

In 1962 the South Dakota Legislative Council recommended a constitutional amendment providing that permanent school funds can be invested in corporate stocks and bonds up to a 50% limitation.

CALIFORNIA

A 1961-63 report of the Joint Interim Committee of the California Legislature held extensive hearings on the desirability of a constitutional amendment to eliminate a restriction which prevents California retirement funds from investing in common stocks. The committee summarized their findings as follows:

1. Many public and private retirement funds invest a portion of their assets in common stocks.
2. A retirement system invested partly in common stocks and partly in fixed dollar investments apparently provides a more adequate retirement income in terms of purchasing power under all types of economic conditions.
3. The increased costs of administering the system's investment program if the constitutional amendment is accepted, would be negligible in relation to the increased income.

NEW JERSEY

New Jersey was among the first of those states which established central investment agencies. The New Jersey Investment Council has broad investment powers including the power to invest in corporate stocks and bonds.

MINNESOTA

In November, 1962 the electorate of Minnesota approved a constitutional amendment authorizing the use of corporate bonds to the extent of 40% of book value and stocks to the extent of 20% from Minnesota's trust funds.

WISCONSIN

In 1951 the state of Wisconsin created a centralized investments agency which has the authority to invest up to 25% of all retirement funds in common stocks. Wisconsin has realized a substantial appreciation in value of the retirement funds through improved fund management and investment in common stocks. The rates of return for these funds are currently 4.15% and 4.7% as opposed to about 2.9% in 1951. The benefits of this increased income will result in a 25 to 30% increase in retirement payments to teachers and other public employees.

NEW MEXICO

In 1959 New Mexico created a state investment council which has the authority to invest up to 25% of all funds under its control in common stocks.

Conclusions and Recommendation

The collective experience of other states, as well as the considered and unanimous opinion of experts in the investment field, verify the accuracy of the following statement.

> ***The obstacles to the attainment of maximum net earnings which most frequently dilute the quality of investment management in public retirement systems are the following:***
>
> 1. ***Attempts to legislate good investment management by elaborate statutory restrictions;***
> 2. ***Devotion to the palpably fallacious notion that local investments should receive favored treatment; and***
> 3. ***Short-sighted penny-pinching in providing for careful administration of portfolios.***[33]

The Council recommends that if a centralized investment agency is created as recommended, and functions successfully for several years, the types of permissible investments for all state funds be broadened. The Trust and Legacy Fund, the two retirement funds and the Industrial Accident Fund should all eventually be permitted to purchase common stocks. For the benefit and protection of the beneficiaries of these funds it is essential that this step be taken. The percentage of each fund to be invested in common stocks can be set by statute as low as the legislature desires.

The Council emphasizes, however, that a central investment agency staffed by experienced professional investment people must be established before the purchase of equities is authorized. For this reason, the proposed bill revising investment laws does not alter the present restrictions on investments. The purpose of this law is to establish a central investments agency and this proposal can be justified without regard to relaxing limitations on types of investments. These limitations are simply rewritten into the proposed bill.

The proposed constitutional amendment (See Appendix B) would establish the standard of the "prudent man rule" for investment of the trust and legacy fund. This rule, which has been continuously interpreted by courts for many years, governs the investment of private trust funds in Montana. Under current market conditions, it would permit the investment of between 25 to 35% of the fund in common stock. If the amendment is approved, it will be necessary for the legislature subsequently to amend the investment statutes — the constitutional amendment is not self implementing. The legislature could establish a specific percentage limit by statute.

[33] Roger F. Murray, *Report to the Ohio Legislative Commission on the Retirement Systems of the State of Ohio* (1962), p. 2.

There is no reason why the legislature should not have continuing authority to amend the statutes governing investment of public funds. The present constitutional amendment freezes the investment policy of the state to what may have been appropriate thirty years ago.

> *... Overall investment policy should be highly flexible. Conforming to the objective of balancing safety of principal with income will not allow a stringent policy as to the proportion of investments in government securities, corporate bonds and stocks. This depends upon the offerings and market prices at a given time. No single rigid investment formula is always best for the fund as a whole or to the components. One authority speaking on the bond segment alone stated for example that a bond investment policy appropriate for 1957 would not have been appropriate for 1958 and statutory restrictions placing money in tight compartments will not permit the most efficient management... Since market conditions for each media change, such restrictions can preclude the maximum productivity otherwise available through a highly flexible authority such as the prudent man rule.*[34]

When the time comes to liberalize statutes governing investments, the legislature should avoid the temptation to establish rigid rules, although a reasonable limitation on the percentage of investment in common stocks would not be improper.

> *... a statute can serve its proper function by blocking out a reasonable area within which a trustee may operate using his discretion in selecting particular securities. A statute may define the limits beyond which the portfolio manager must not go and suggest standards by which he should be guided without attempting to provide a general education in security analysis. The statute would define the rules of the game but would not attempt to call the plays.*[35]

---

[34] Oregon Legislative Fiscal Committee, *Investment Management* (1962), p. 19.

[35] Alek Rozental, *Investmen Policy of Minnesota Trust Funds*, School of Business Administration, University of Minnesota (1956), p. 55.

Chapter III

TREASURY CASH MANAGEMENT AND THE INVESTMENT OF IDLE FUNDS

The operation of state government is one of Montana's largest enterprises. As with a private corporation, one of the most productive fields in financial management is the proper custody, control and utilization of cash. The level of bank balances, cash requirements and investment of idle cash require constant study in order to achieve businesslike results. As governmental expenditures rise, state officials are constantly searching for added sources of revenue. This search often overlooks one of the partial solutions—proper utilization of idle cash to secure interest earnings.

> ***Cash balances of State and local funds which are in excess of operating needs can either be put to work drawing interest and thereby producing additional revenue for the State or local government, or they may be allowed to lie idle. If the latter course is followed, a waste of public funds occurs, just as real as an unnecessary or over-priced procurement contract or an uncollected tax obligation.***[1]

Cash management practices prevalent in private business often are adaptable to state government. Many large corporations have established formal divisions for the sole purpose of continuously analyzing cash flow and preparing daily statistics and trends for inclusion in periodic reports. Detailed historical information is kept current and is used to forecast beginning bank balances, receipts and expenditures, and new cash balances. For example, one large public utility reprojects receipts and disbursements each week and exercises special controls over all large contracts and other payment obligations. In this company every contract or purchase order over $10,000 is specially flagged. As soon as information comes into any part of the organization concerning delivery against the contract, the treasurer is immediately informed. The treasurer then will know that on a certain future date he will have to process the payment and will organize his finances accordingly. This may require a temporary loan, or, if in a period when surpluses are invested, sale of a U. S. treasury bill or withdrawal from an interest bearing bank account.

Some of the benefits of a cash forecast and control program are listed below.

1. Idle cash in the treasury can be invested or placed in interest bearing time deposits to earn revenue for the state. By idle cash is meant any surplus moneys in the treasury not needed to maintain active, non-interest bank accounts for the handling of current transactions. Such cash can only be effectively invested if expenditures and receipts are accurately predicted. The length of time of the investment depends on forecasting how long the cash will be idle.
2. A well organized cash management program encourages effective budget control, including the programming of controllable expenditures.
3. Advance knowledge of future treasury condition reduces the problems of "lean period" financing. It minimizes the need for, or at least gives advance notice of inter-fund loans.

Once a program of cash flow projection has been established and its reliability has been tested, probable cash balances which can be utilized for short-term investment can be accurately predicted. Before this cash can be invested, however, it is necessary to establish poli-

---

[1] Advisory Commission on Intergovernmental Relations, *Investment of Idle Cash Balances By State and Local Governments* (1961), p. 1.

cies as to the amount of balances which should be retained in active bank accounts to handle normal transactions.

> ***Basically the treasurer should feel no responsibility for maintaining active deposits other than amounts sufficient to compensate the banks for the work they perform which will provide reasonable, commercial profit margin.***[2]

Among the several different types of short term investments available for treasury cash are:

1. Time deposits, which are inactive interest bearing accounts similar to a savings account. The principal is safe, the money is available upon short notice, and the earnings are reasonably good. Money for short term investment can be placed in 30-day or 90-day notice time-deposits. Money which is available for longer periods of time can be deposited in 1-year notice time-deposits at slightly higher interest rates.
2. Treasury bills are securities of the United States limited in maturity to a period of one year or less. They are issued on a discount basis and the return on the investment is the appreciation between the price at which they are purchased and the maturity value of one hundred. Treasury bills are currently issued with a maturity of 90 to 92 days in thirteen weekly series. They are offered at a competitive auction each Monday for payment every Thursday. Treasury bills provide a highly liquid investment for short term funds with relatively little risk.

Treasury Cash Management in Montana

Demand deposits of state funds are maintained in 122 Montana banks to provide state agencies which collect money in points throughout the state a convenient method of depositing in the state treasury. Once deposited, the money loses its identity for purposes of investment, although the state treasurer and state controller maintain fund and account records in Helena.

For the fiscal years 1961-62 and 1962-63 treasury cash on demand deposit in all banks averaged about $18 million. In addition to these demand deposits, an average of approximately $2 million was invested in time certificates of deposit held by Montana banks, and $10 million was invested in long term U. S. treasury bonds. The total interest earnings on treasury cash of approximately $30 million for these two years averaged $480,000 annually.

TREASURY CASH

Demand Deposits

	1961-62 Fiscal Year		1962-63 Fiscal Year
Highest monthly balance (June)	$23,414,000	(March)	$21,709,000
Lowest monthly balance (Feb.)	13,878,000	(Jan.)	10,353,000
Average high monthly balance	20,695,000		19,895,000
Average low monthly balance	15,979,000		15,305,000
Highest degree of fluctuation (Feb.)	7,706,000	(Feb.)	9,704,000
Lowest degree of fluctuation (July)	1,995,000	(April)	1,960,000
Average degree of fluctuation	4,699,000		4,590,000
Average monthly balance	18,329,000		17,600,000

Time Certificates of Deposits*

1961-62 Fiscal year average	$ 1,400,000
1962-63 Fiscal year average	2,300,000

U. S. Treasury Bonds

1961-62 Fiscal year	$10,000,000
1962-63 Fiscal year	10,000,000

*The amount of time certificates of deposit has been steadily increasing since early in 1961, when the Council began its study In July, 1964 CDs totaled 4½ million dollars.

[2] League of California Cities, *Treasury Management and the Investment of Idle Funds.* (1956), p. 8.

The constitution vests the state depository board with "full power and authority to designate depositories with which all funds in the hands of the state treasurer shall be deposited, and at such rate of interest as may be prescribed by law." Section 79-301, R.C.M. 1947 directs the state treasurer to deposit public moneys in his possession in solvent banks in the state, and provides that the state depository board may require the payment of interest on daily balances "at a rate to be agreed upon between the depository bank and said state depository board."

As a practical matter the responsibility for depositing moneys in banks and investing idle cash lies with the state treasurer. Periodically the treasurer writes depository banks asking them to place part of the treasury balance in time certificates of deposit (hereafter referred to as "CDs"). Two general offers have gone out to the banks since 1960; a copy of one form letter appears in *Appendix C.* No guidelines or ratios are suggested; the decision as to how much will be put in CDs is left entirely to the bank. It is not unusual for banks to refuse to take any CDs. The offer is made with the understanding that the state treasurer will leave an amount equal to the amount in CDs on demand deposit for a full year. Consequently, the theoretical effective rate of return to the state on a 3½% CD is 1¾%; however, in practice demand deposit balances often substantially exceed the amount of CDs, but seldom fall below that level. Communications with banks are always in the form or requests, and although banks electing not to invest in certificates of deposit lose the guarantee of an equal amount on demand deposit, there is apparently no consistent effort to penalize these banks by drawing demand deposits down to a level below that of banks which have invested in CDs. The treasurer has adopted a policy to limit the amount of certificates of deposit in any one bank to $50,000.

Aside from anticipating semiannual disbursements for the school foundation program, no attempt is made to predict cash flow or to forecast transactions in order to anticipate balances which might be available for investments. *Chart 6* shows the proportions of treasury cash in long term securities, time certificates of deposit, and demand deposits for the 1962-63 fiscal year.

According to the treasurer, bank balances are reviewed about every ten days, and the accounts are periodically drawn down to insure that balances do not exceed collateral. After a large disbursement such as the school foundation payment, bank balances are allowed to build up for two or three months. To make the 1964 school payment the treasurer even had to reduce the demand deposits in some banks below the level of certificates of deposit, something they try never to do.

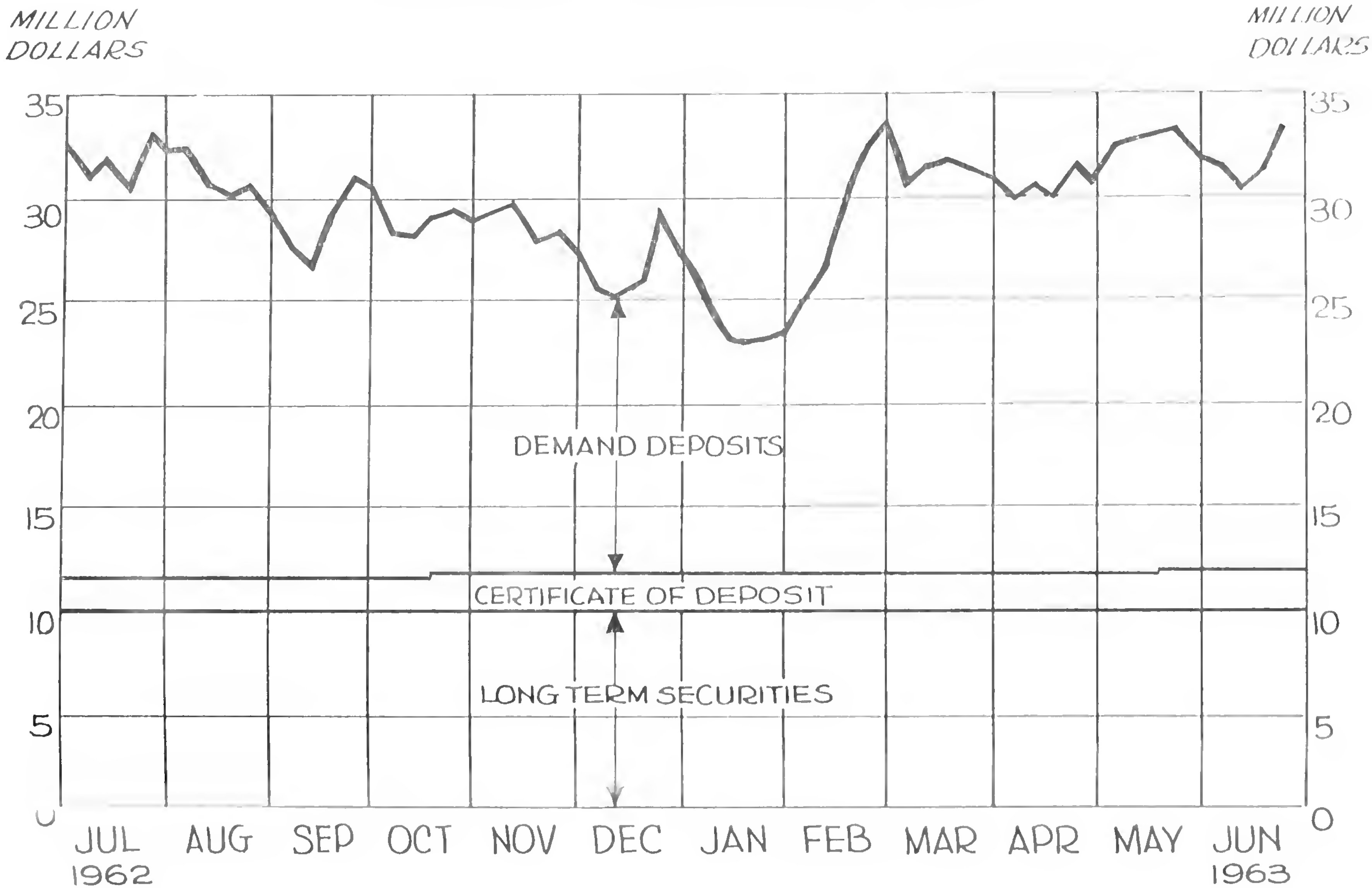
Depository Practices

In order to determine which portion of a bank balance should earn interest, it is necessary to estimate the value of services provided to the depositor. It is assumed that the state should be treated like any commercial depositor, unless special circumstances require otherwise. Once the value of services is determined, the size of the average minimum balance necessary to compensate the bank for its services can be set. Although demand deposits carried in Montana banks are said to be compensating balances, the treasurer has not attempted to determine the cost of servicing the accounts, which is what the banks should be compensated for. A major portion of the Council's time in reviewing treasury cash investment practices was devoted to estimating a "price tag" for these services in order that potential interest earnings could be gauged.

> ***. . . the most forward looking banks will surely have come to the conclusion . . . that . . . the commercial or active account . . . should be maintained only at a sufficient balance level to compensate the bank for the service required. (checks written, deposits taken in, returned items processed, statements rendered, special services and advice given) . . . But once this proper level of commercial balance has been determined to the mutual satisfaction of both parties, all other funds should be placed in interest-bearing accounts without regard to ratios or any other outside factors. [The state is] just as entitled to earn money on its funds as are business corporations or individuals; indeed they would be doing their taxpayer constituents a disservice if they failed in this regard.***[3]

[3] *Ibid.*, p. 12.

CHART 6. STATUS OF TREASURY CASH IN MONTANA



HELENA BANKS

All state warrants which are cashed are eventually cleared through one of the three Helena banks. Consequently the accounts are extremely active and cannot be strictly compared to the much less active accounts outside of Helena. At the request of the Council, analyses of these accounts were prepared by the Helena banks and were reviewed during the course of the study. During the period covering July 1, 1961 through June 30, 1963, more than one hundred deposits per month, and warrants deposited or cashed in excess of 25,000 per month for one of the banks was not unusual. Average balances in the three banks for this period totaled approximately 10.5 million dollars.

In estimating earnings on the state's accounts, "float" and "carryover" for items in the process of collection were deducted from ledger balances. The effective balances on which the banks could earn interest were consequently substantially reduced. Estimated costs to the banks were based on charges of 2c per item for checks deposited or cashed, 5c per deposit, and c per check paid. Miscellaneous expenses for the two largest Helena banks were estimated at $527 and $833 monthly.

Net bank earnings on the Helena accounts are estimated to be about $35,000 annually by the banks themselves. However, the Council did not attempt to pass judgment on all of the factors employed by the banks in their analyses. For example, after deducting float, carryover, average amount of checks deposited, and 16½% to allow for the reserve requirement, 50% of the resultant "average collected balance" was subtracted "due to the volatile nature of the account." If it were determined that this 50% of the balance had some earning capacity the earning estimate would be considerably increased. If the earnings of this portion of the account were judged to be 1%, for example, the estimate of the banks' annual earnings would increase by $40,000.

Accounts in Helena, banks are extremely volatile, another factor which may reduce the earning ability of the account. For one month during the period mentioned above the account in one bank fluctuated from less than $2 million to $7½ million. If the balances were stablized through attentive treasury fund management, the possibility of additional earnings would be enhanced. Some changes in disbursement and receipt schedules might be desirable. For example, if the school foundation payments were released on three occasions annually, instead of two, the potential interest earnings could increase by more than $30,000 annually as a result of larger average treasury balance.

OUTSIDE BANKS

State offices located outside of Helena which collect moneys for deposit in the state treasury usually deposit directly in a local bank. State liquor stores account for the great bulk of such deposits, although 17 agencies, more than half of which are occupational licensing boards, also deposit locally for the state treasurer's account.

A list of the time deposits and average demand deposit balances for the months of September, 1962 and September, 1963 for the 122 banks outside of Helena is shown in *Appendix D*. Generally speaking there is considerable fluctuation in these accounts, and although September was selected as a typical month, the average balance of any given bank often varies substantially from month to month.

Although the accounts in banks outside of Helena are technically demand deposits, they are not subject to the same degree of activity found in normal commercial accounts. Deposits by liquor store vendors vary from once each week to several times daily. The only checks or debit items drawn upon the accounts are treasurer's drafts, averaging two or three monthly.

An analysis of liquor store deposits revealed that approximately 56,000 checks are deposited annually. At 2c per item, the charge most commonly quoted by banks surveyed, the

annual charges would amount to $1,122. Account maintenance charges of $1.00 per month would add another $1,440 for a total of $2,562.00 in service charges annually. Therefore, a liberal estimate of all charges for all banks outside of Helena would not exceed $5,000 annually, and total minimum balances of $300,000 should adequately compensate the banks for their services.

While banks in towns where institutions or university units are located provide additional services, presumably they are adequately compensated through the retention of local accounts such as sinking funds, or student or inmate trust accounts, many of which are substantial in size.

During the two year period analyzed, demand deposits in the outside banks averaged about 7.5 million dollars, and CDs averaged $1,850,000, for a total of about $9,350,000. The average annual interest income on CDs was about $50,000; thus the average rate of interest paid on all moneys in outside banks was approximately ½ of 1% annually.

Employing these same historic figures, and estimating a minimum average investable balance of $9,000,000, the expected annual interest earnings at 2.5% would be $225,000—almost five times more than was actually realized.

There is a decided disparity among banks in the ratio of time to demand deposits. Some bank balances are held to a minimum. For example, the demand balance in one bank which held a $30,000 time certificate of deposit varied from a low of $12,000 to a high of $25,000 during a one year period—the balance never equaling the amount of the CD. The balance of another bank which held a CD in the amount of $51,000 varied from $39,000 to $55,000.

Other banks receive much better treatment. The demand balance of one large bank with a $50,000 CD never dropped below $246,000 for a period of one year. The minimum balance in another bank for a period of a year was $251,000; the bank held $25,000 in CDs. The balance in a bank holding no CDs did not fall below $83,000 for an entire year.

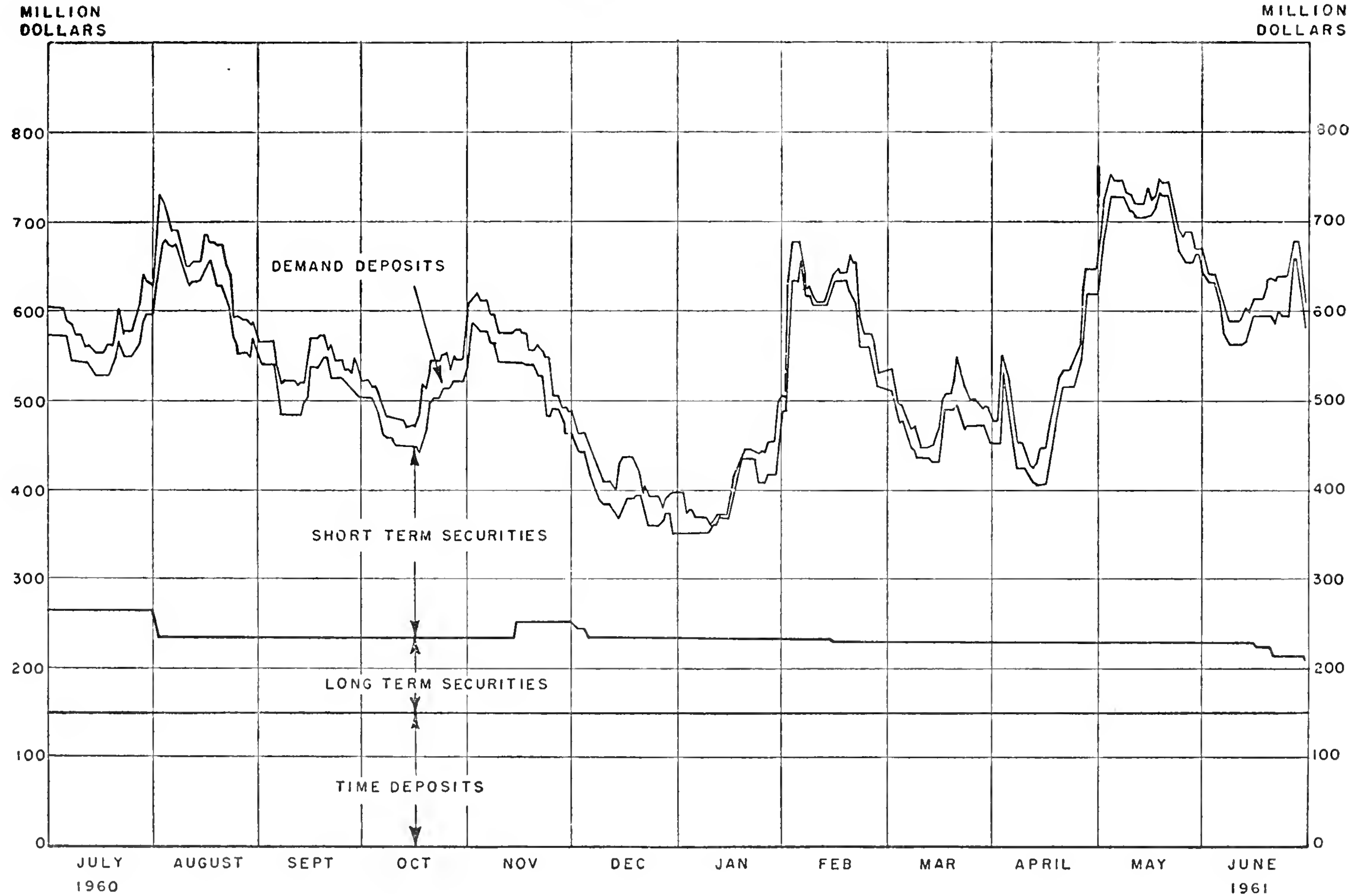
Conclusions and Recommendations

There is no program of treasury cash management in Montana; invested balances bear little or no relation to the amount of idle cash. The state depository board, which meets only three or four times a year, does not exercise effective control over the custody and investment of state funds. The last time the board or, for that matter, apparently any one, analyzed the state's cash position was in 1950 when a special committee was appointed to examine the possibility of receiving greater investment income. As a result of this inquiry $10 million was, and still is invested in long term U. S. government bonds. *Chart* 6 shows the relationship between the invested and uninvested portion of treasury cash. About 18 million of a total of 30 million dollars, or 60%, was held in non-interest earning demand deposits.

Compare *Chart* 6 with *Chart* 7 which shows the effect of the treasury management program in California, where the proportion of non-interest bearing demand deposits is consistently held to less than 6% of the total. In California an extensive cash position estimation program is conducted. Available revenue and disbursement information is gathered and analyzed and used to prepare a "Forecast of Transactions" covering the ensuing five or six weeks. The state treasurer daily determines amounts available for investment, or necessary to liquidate to meet warrant redemption disbursements in accordance with current available data. Treasury bills are purchased or sold on a daily basis, and are sometimes held for periods as short as two days. As a result, the amount of money invested fluctuates with total cash balances, and demand deposits are held to a minimum. In Montana, because the cash position is not constantly analyzed, invested amounts do not parallel total cash balances.

The absence of an imaginative and vigorous investment program over the years has resulted in a loss of millions of dollars of non-tax revenue. The procedures and policies followed

CHART 7.—STATUS OF TREASURY CASH IN CALIFORNIA.



in the treasurer's office are historic and apparently have not differed gre[illegible] from administration to administration. Perhaps one reason for the lack of a professiona[illegible] approach to investments in the office is the prohibition against the treasurer succeeding [illegible]mself.

Because such a large portion of idle cash is in demand deposits, it [illegible]lso of limited use to the banks. While demand balances in some banks exceed the amoun[illegible] CDs by $200,000, the accounts are subject to large abrupt and often unannounced withd[illegible]wals (reduction of the balance by three quarters of the total amount is not unusual) thus l[illegible]ting the useability of the funds.

The Council recommends that the state investment council and its i[illegible]tment officer be given responsibility for the investment of treasury cash. A program for [illegible]e management and investment of idle cash could be coordinated with long term investment [illegible]nd supervised by the same personnel. The Council estimates that additional annual intere[illegible]come in excess of $200,000 would accrue to the state under such a program.

Section 15 of the bill appearing in *Appendix A* vests authority in the [illegible]te investment officer to invest treasury cash. Section 16 establishes the general polic[illegible]or investment of treasury cash and requires the maintenance of non interest-bearing ba[illegible]s to compensate banks for the cost of maintaining treasury accounts.

The Council feels that an important consideration in establishing inv[illegible]ment policy is to retain as much money within the state as is commensurate with the r[illegible]ation of an adequate interest income. A recent study of the potential benefits to a state [illegible]ugh investing as much money locally as possible reported that the differential between in[illegible]st rates on certificates of time deposits in local banks and the rate of return on treasu[illegible]ills

> ***was far more than compensated for by the corporation inco[illegible] tax paid by the bank on its earnings from the state fund deposits [illegible]nd the other tax revenues generated by the increased income, busines[illegible]ctivity and property valuation generated by loans based on the deposit. [illegible]n addition, the citizens of the state profited from higher [illegible]mployment, [illegible]usiness expansion and economic growth. A thus far unmentioned consid[illegible]tion is the enhanced ability of the small town banks to buy municipal bo[illegible]ds for which there is little market elsewhere.***[4]

The banking community of Montana has emphasized the need for lo[illegible]ble funds in the state, and has enumerated the indirect benefits whic[illegible] [illegible]crued to the state [illegible]m the deposit of funds within the state as "corporate income taxes, and increased proper[illegible] [illegible]nd other taxes which result from the additional income generated by deposit of state [illegible]nds." In general terms, this statement is probably true. However, the state cannot be exp[illegible]d to sacrifice an appreciable portion of interest income under the somewhat uncertain expect[illegible]on of additional tax collections. It is not at all clear that the deposit of state funds in bank [illegible]ill generate additional income, and consequently more taxes in all instances. It is clear [illegible] *excess* demand deposits result in a sacrifice of interest income to the state.

The statewide ratio of loans to deposits indicates that Montana woul[illegible] [illegible]ot qualify as a capital short area. For the past several years Montana has had the low[illegible] loan to deposit ratio of the eleven western states. However, because of the significant [illegible]parity between communities within the state this statewide ratio is not conclusive. There [illegible] obviously some capital short areas within the state, or perhaps more accurately stated, the[illegible] are some banks within the state which are loaned up to capacity. The loan to deposit rat[illegible] [illegible]mong Montana banks varies from 12% to 70%.

Offering public moneys at attractive rates of interest to banks with lo[illegible] loan to deposit ratios would probably only result in windfalls to the banks since there is li[illegible] likelihood that

[4] R. Joseph Monsen and Garth L. Mangum, "Alternative Investment Outlets for Idle State Operatin[illegible] [illegible]nds," *State Government Magazine*, (Summer 1963), p. 189.

the money would be put to work in the economy. On the other hand, if cash is channeled into areas where these ratios are high, beneficial indirect results could be expected. In other words, while the contention that depositing state moneys in banks aids the economy is generally true, the desired results cannot be obtained by indiscriminately scattering cash throughout the state.

Because the details of administration of the investment program cannot be the subject of legislation, the balancing of the various interests involved and a determination of the policy that will most benefit the state must be the responsibility of officials in charge of the program. However, if the recommended legislation is approved, the Council suggests that the investment officer regard the need for loanable funds in Montana communities as an important factor in his investment policy. Once the amount of working capital for the transaction of state business has been estimated, and once the necessary average balances are established to compensate banks for servicing the account, as much as possible of the money remaining should be invested in time certificates of deposit with rotating maturities. The initial offer could be based on a percentage of capital and surplus. Because certificates of deposit alone would not afford the flexibility or liquidity necessary for optimum investment of idle cash, it might be desirable to maintain a portfolio of treasury bills invested for periods as short as a few days.

The establishment of such a program would provide badly needed investment capital—about $10 million currently—in areas within the state where the demand is greatest. There is no point in being democratic in the distribution of idle funds; they should be placed out where they will do the most good, at reasonable rates of interest. If there is a scarcity of loanable funds in a community, it is apparent that the demand for money will be reflected by the local bank's willingness to pay a reasonable rate of interest on any deposits over and above those maintained strictly for the purpose of compensating the bank for its services.

Section 79-3[illegible], R.C.M. 1947 requires that every bank in which treasury funds are deposited must place with the state treasurer's office collateral in the form of U. S. government securities or municipal bonds at least in the amount of such deposits in excess of the amount guaranteed or insured by law. The purpose of the collateral requirement is to give the state preferred status in the event of liquidation of a depository bank. The collateral requirement, which has been in effect for more than fifty years, appears to be no longer necessary. The practice of pledging assets reduces the liquidity of the banking system and curtails its lending capacity. Because pledged assets cannot be liquidated to meet a decline in deposits or to accommodate loan demands, for practical purposes they are frozen assets. As of 1955, only 31 states require collateral for state or local governmental deposits.

If deposits are based on a percentage of capital and surplus, the state's risk will be spread to such an extent that the probability of loss is infinitesimal. Since the beginning of Federal Deposit Insurance in 1934 only five banks have failed in Montana and in every case full restitution to depositors was made.

The Council recommends that the collateral requirement for state deposits be eliminated.

Appendix A

A BILL FOR AN ACT ENTITLED: "AN ACT RELATING TO THE INVESTMENT OF MONEYS IN THE STATE TREASURY AND STATE DEPOSITARY PRACTICES; CREATING A STATE INVESTMENT COUNCIL AND THE OFFICE OF STATE INVESTMENT OFFICER; PROVIDING AN APPROPRIATION FOR THE STATE INVESTMENT COUNCIL; AMENDING SECTIONS 31-205, 68-701, 75-2708, 79-306, 79-1101, 79-1102, 81-101, 81-102, 81-201, 81-209 and 92-1112, R.C.M., 1947; AND REPEALING SECTIONS 79-301, 79-303, 79-304, 79-305, 79-1105, 79-1201, 79-1203, 79-1206, 79-1207, 79-1208, 79-1209, 79-1211, 79-1212, 79-1213, 79-1214, 79-1215, 79-1216, 81-1001, 81-1002, 81-1003, 81-1004, 81-1005, 81-1006, 81-1007, AND 81-1008, R.C.M. 1947."

BE IT ENACTED BY THE LEGISLATIVE ASSEMBLY OF THE STATE OF MONTANA:

Section 1. There is hereby created a state investment council consisting of six members. The council consists of the state treasurer as a non-voting member, a member of the public employees retirement system, a member of the teachers retirement system, and three public members. Public members of the council shall be competent and experienced in the field of investments.

Section 2. Members representing retirement systems shall be appointed by the governor with the consent of the senate from a list of three nominees submitted to him by the governing board of each system. Public members shall be appointed by the governor with the consent of the senate. The original appointed members of the council shall serve for one, two, three, four, and five year terms. An appointment to replace a member whose term has expired shall be for five years. An appointment to replace a member whose term has not expired shall be for the remainder of the term. A member may be removed only for cause.

Section 3. The council shall elect a chairman from among its voting members. Actions of the council shall be by majority; however, at least one member representing a retirement system, one public member and one other voting member must be present to constitute a quorum. The public members of the council shall receive twenty-five dollars ($25) per day while attending council meetings. Members residing outside Helena shall be reimbursed for actual and necessary expenses incurred in attending meetings.

Section 4. The council shall appoint a full time state investment officer who shall have a minimum of five years of progessively responsible full-time paid experience in securities analysis and securities portfolio management. The council shall set the salary of the investment officer.

Section 5. The state investment officer shall perform his executive and administrative duties in conformity with the policies, principles and directives determined by the council. The state investment officer shall appoint all employees of his office, and may retain outside investment counsel.

Section 6. The state investment council shall formulate and adopt policy regulations pertaining to the kind or nature of investment of moneys in the state treasury, and may impose limitations, conditions, or restrictions upon the methods, practices, or procedures for investment, reinvestment, purchase, sale, or exchange transactions of the state investment officer.

Section 7. Subject to any limitations, conditions and restrictions contained in this act or in regulations adopted by the council, the state investment officer may purchase, sell and exchange securities and otherwise invest and reinvest any moneys in the state treasury. He

shall see that moneys invested under the provisions of this act are at all times handled in the best interests of the state and the beneficiaries of the funds. All proposed transactions of the investments officer shall be kept confidential by members of the council and the investments officer.

Section 8. Securities or investments purchased or held under the provisions of this act may be sold or exchanged for other securities or investments; however, no sale or exchange shall be at less than the current market price.

Section 9. The council shall meet at least once each month to consult with the state investment ofifcer with respect to his work, and shall have access to all files and records relating to the work of the investment officer. The council shall periodically inspect and review the accounts and funds administered and invested by the investment officer.

Section 10. A member of the council or a firm in which a member of the council has a financial interest shall not sell securities to the state nor benefit directly or indirectly from a transaction of the state investment officer involving the purchase, sale or exchange of securities.

Section 11. Within fifteen days after the close of each month the investment officer shall prepare and make available to the council, the press and the public, a report of the operations of his office during that month. Each report shall include a detailed summary of investment, reinvestment, purchase, sale or exchange transactions setting forth, among other things, the securities bought, sold and exchanged, the dates of such transactions, the prices paid or obtained, the names of the dealers involved, and a statement of the funds, subfunds or accounts involved.

Section 12. The state investment officer may invest the trust and legacy fund only in

(1) Bonds of school districts within the state of Montana

(2) Bonds of the several counties and cities of the state of Montana

(3) Bonds of the state of Montana

(4) Capitol building bonds of the state of Montana

(5) Bonds issued by the federal land bank

(6) Interest bearing warrants upon the general fund of the state

(7) Interest bearing warrants upon the general fund, the poor fund, the road fund, or the bridge fund, of the several counties of the state, and

(8) Bonds, notes or other obligations of the United States and bonds, notes or other obligations fully guaranteed by the United States as to principal and interest.

All investments purchased belong jointly to the accounts or subfunds within the trust and legacy fund and such subfunds or accounts shall share capital gains, income and losses pro-rata.

Section 13. The state investment officer may invest the agency fund only in

(1) Securities which are direct obligations of the United States government; securities which are guaranteed as to principal and interest by the United States government; securities issued by instrumentalities of the United States government.

(2) General obligation bonds of school districts within the state of Montana; general obligation bonds of the several counties and cities of the state of Montana; general obligation bonds of the state of Montana; capitol building bonds of the state of Montana; bonds issued by the federal land banks; bonds issued to construct buildings for state

agencies or institutions; interest-bearing warrants upon the general fund of the state and interest-bearing warrants upon the general fund, the poor fund, the road fund, the retirement fund, or upon the bridge fund of the several counties and school districts of the state of Montana.

(3) The obligations, and/or stock where stated, of the following agencies of the government of the United States of America, whether or not such obligations are guaranteed by such government:

(a) Commodity credit corporation.

(b) Federal intermediate credit banks.

(c) Federal land banks.

(d) Central bank for co-operatives.

(e) Federal home loan banks, and stock thereof.

(f) Federal national mortgage association, and stock thereof when acquired in connection with sale of mortgage loans to such association.

(4) First mortgages on unencumbered real property which are guaranteed or insured by the United States government or any agency or corporate agency thereof, in the amount of fifty per centum (50%) or more of the loan made in the event of default, and in obligations of housing authorities subject to the terms and limitations of Section 35-143; however, no more than fifty per centum (50%) of one account shall be invested in such mortgages.

(5) First mortgage bonds, debentures, notes and other evidences of indebtedness issued, assumed or guaranteed by any solvent and operating public utility corporation existing under the laws of the United States of America or any state thereof which bonds, debentures, notes and other evidences of indebtedness are, at the time of such investment, within the three (3) highest quality grades for the rating of such bonds, debentures, notes and other evidences of indebtedness by any nationally recognized investment rating agency.

(6) Equipment trust obligations or certificates adequately secured and evidencing an interest in transportation equipment, wholly or in part within the United States of America, which obligations or certificates carry the right to receive determined portions of rental, purchase, or other fixed obligatory payments to be made for the use or purchase of such transportation equipment, and which obligations or certificates are, at the time of such investment, within the three (3) highest quality grades for the rating of such obligations or certificates by any nationally recognized investment rating agency.

All investments purchased for an account in the agency fund shall be kept separate and all capital gains, income and losses shall be credited or charged to the account for which the investments were purchased.

Section 14. The sinking fund, and the bond proceeds and insurance clearance fund may be invested in bonds, notes and other obligations of the United States, and bonds, notes or other obligations fully guaranteed by the United States as to principal and interest. All investments purchased belong jointly to the accounts or subfunds within the sinking fund and the bond proceeds and insurance clearance fund and such accounts or subfunds shall share capital gains, income and losses pro-rata, except that income obtained from investing the proceeds from the sale of bonds shall be credited to the sinking fund account for the retirement of such bonds.

Section 15. All other moneys in the state treasury not a part of the trust and legacy fund, the agency fund, the sinking fund or the bond proceeds and insurance clearance fund shall be invested as treasury cash by the state investment officer in:

1. Bonds, notes or other obligations of the United States and bonds, notes or other obligations fully guaranteed by the United States as to principal and interest.
2. Time certificates of deposit issued by a bank designated as a state depository by the state depository board.

Interest or other income derived from the investment of treasury cash shall be credited to the general fund.

Section 16. Treasury cash shall be invested in such a way as to realize the maximum return to the state consistent with safe and prudent treasury management. The state treasurer shall deposit treasury cash only in those banks which are designated as depositories by the state depository board. The state investment officer shall fix the rates of interest to be paid by banks on deposits of treasury cash, but shall provide for noninterest-bearing balances to compensate banks for the cost of maintaining treasury accounts.

Section 17. Investments made under this act shall be made with that degree of judgment and care, under circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Section 18. Every state agency charged with the custody or administration of a fund or account which is subject to investment under this act shall provide the state investment officer with any information that he requests regarding the fund or account.

Section 19. All securities purchased or held shall be in the physical custody of the state treasurer unless the state investment officer arranges for the deposit with a fiscal agent in any of the financial centers, or with a local bank or trust company, or with a registered broker or dealer, of securities that he considers advisable to be held for safekeeping or for collection of principal or interest.

Section 20. The state treasurer shall collect the principal, interest or other income on securities in his custody as directed by the state investment officer, and shall deposit such moneys into the proper fund, subfund or account. The state investment officer shall furnish the state treasurer with the information necessary to perform these functions.

Section 21. The state investment officer shall keep, for each subfund or account for which investments are made, a separate account designated by name and number on which shall be recorded the individual amounts and totals of all investments belonging to such subfund or account. The state treasurer shall notify the state investment officer of every receipt and collection or disbursement in order that the state investment officer may record such transaction to the particular subfund or account.

Section 22. The state investment officer shall report monthly to every state agency or official having a beneficial or administrative interest in funds administered by the investment council. The report shall show the changes in investments made during the preceding month and, in addition, shall furnish the details of an investment transaction if requested by the agency or official.

Section 23. There is hereby appropriated from the general fund to the state investment council one-hundred thousand dollars ($100,000) for the biennium ending June 30, 1967.

NOTE: Sections 24 through 37 of this bill are only amendments and repeals of existing statutes to bring the code into conformity with the above basic legislation. Consequently, they are not reproduced in this report. The code sections affected are shown in the title.

Appendix B

A BILL FOR AN ACT ENTITLED: "AN ACT TO SUBMIT TO THE ELECTORS OF MONTANA AN AMENDMENT TO THE CONSTITUTION RELATING TO THE CUSTODY AND INVESTMENT OF PUBLIC FUNDS AND REMOVING RESTRICTIONS ON THE PERMISSIBLE TYPES OF INVESTMENTS FOR MONEYS IN THE CUSTODY OF A PUBLIC AGENCY BY AMENDING SECTION 3, ARTICLE XI OF THE CONSTITUTION OF MONTANA AND REPEALING SECTION 8, ARTICLE XXI OF THE CONSTITUTION OF MONTANA."

BE IT ENACTED BY THE LEGISLATIVE ASSEMBLY OF THE STATE OF MONTANA:

Section 1. Section 3, Article XI of the constitution of Montana is amended to read as follows:

"Section 3. Such public school fund shall forever remain inviolate, guaranteed by the state against loss or diversion, *and shall* be invested, (matter deleted) under the restrictions to be provided by law. *Investment of moneys in the public school fund, other trust funds originating in federal land grants, and all other moneys in the custody of a state, county or municipal agency, shall be made with that degree of judgment and care, under circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived. No provision of the constitution shall be interpreted as prohibiting the investment of moneys in the custody of a public agency in the bonds or stock of a private corporation.*"

Section 2. Section 8, Article XXI of the constitution of Montana is repealed.

Section 3. When this amendment is submitted to the electors of the state of Montana there shall be printed on the ballot the title and sections 1 and 2 of this act and the following words:

"☐ For the above amendment.

☐ Against the above amendment."

Appendix C

STATE OF MONTANA

Office of

The State Treasury

Helena, Montana

Gentlemen:

On January 4, 1962 the State Depository Board comprised of the Governor, State Auditor and State Treasurer held a meeting at which the matter of investment of cash in banks was discussed.

A report by the State Treasurer advised that banks with time deposits of state funds were willing to increase the rate of interest on their certificates to 3½% and 4% from 2½% and 3% per annum if they were issued for a period of twelve months. Most of the CDs were for six and nine months.

The State Treasurer reminded the Governor and Auditor of the distributions in February and March, 1962 to the schools of approximately $12,500,000.00 which meant that the cash in banks would be reduced by this amount. These deductions would be against the state treasury accounts in banks, but would increase the county treasury balances in the banks.

Following further discussion the Treasurer was instructed to contact all banks, when the above mentioned distributions were completed to ascertain if they would be agreeable to issuance of an *Automatic Renewal Time Certificate of Deposit* for a period of twelve months and bearing interest at the rate of 3½% per annum. An open demand deposit without interest such as you now have of at least the amount of the Time Deposit would be maintained, unless an urgent need for cash developed.

I would appreciate very much hearing from you at your convenience regarding the above suggested arrangement.

Cordially yours,

EDNA J. HINMAN, TREASURER
STATE OF MONTANA

Appendix D

TIME CERTIFICATES OF DEPOSITS AND AVERAGE DEMAND BALANCES IN BANKS OUTSIDE OF HELENA FOR SEPTEMBER 1962 AND SEPTEMBER 1963

Name of Bank	TIME CERTIFICATES OF DEPOSIT*	SEPTEMBER 1962 AVERAGE DEMAND BALANCE	SEPTEMBER 1963 AVERAGE DEMAND BALANCE
Montana Nat'l. Bank, Absarokee	$ 50.000	$ 51.983	$ 52,770
Baker Nat'l Bank, Baker	5.000	30.068	12.783
Bank of Baker, Baker	5.000	28.093	26.744
Belgrade State Bank, Belgrade	15.000	16.121	20.328
Belt Valley Bank, Belt	20,000	25.900	23.360
Northern Mont. State Bank, Big Sandy	....	21.372	21.186
Citizens Bank & Trust, Big Timber	....	18.828	16.432
Billings State Bank, Billings	50.000	151.645	151.645
First National Bank, Billings	50.000	215.269	213.835
Midland National Bank, Billings	50.000	284.292	290.440
Security Trust & Saving, Billings	50.000	370.992	85.955
First National Bank, Bozeman	50,000[1]	63.485	74.722
Gallatin Trust & Savings, Bozeman	50.000	79.372	96.974
Security Bank & Trust, Bozeman	50.000	123.111	85.955
Powder River County Bank, Broadus	....	23.181	20.303
First National Bank, Browning	25.000	46.928	49.718
First National Bank, Butte	50,000	168.987	300.168
Metals Bank & Trust, Butte	25,000	324.052	328.459
Miners National Bank, Butte	50.000	145.965	145.965
Security Bank, Butte	50,000	145.976	119.828
Stockman's Bank, Cascade	37.000	34.952	34.148
Liberty County Bank, Chester	....	5,829	8,396
First State Bank, Chinook	....	25.927	25.819
Western Bank of Chinook NA, Chinook	....	19,606	24,537
Citizens State Bank, Choteau	....	14,540	16.764
First National Bank, Circle	51.000	52,939	53.576
Bank of Columbia Falls, Columbia Falls	....	34,305	35,465
Yellowstone Bank, Columbus	....	22,371	26,385
Farmers State Bank, Conrad	....	38,216	40.178
Culbertson State Bank, Culbertson	5.000	12.540	14.081
Bank of Glacier County, Cut Bank	....	50,254	82,706
First National Bank, Cut Bank	15,000	76,966	76,966
Deer Lodge Bank & Trust, Deer Lodge	50,000	218,504	197,677
Farmers State Bank, Denton	....	6,005	6.710
State Bank & Trust Co., Dillon	25,000	75,584	74,877

*Certificates of Deposit shown are for September, 1962. If the amount of CD's in September, 1963 differs, the later figure is shown below.

[1] $70,000

APPENDIX D—(continued)

Name of Bank	TIME CERTIFICATES OF DEPOSIT*	SEPTEMBER 1962 AVERAGE DEMAND BALANCE	SEPTEMBER 1963 AVERAGE DEMAND BALANCE
First National Bank, Dillon	25,000[2]	81,799	81,799
Dutton State Bank	....	19,452	12,920
First National Bank, Ekalaka	....	5,668	7,001
First National Bank, Fairfield	....	18,796	14,485
Fairview Bank, Fairview	30,000	21,758	21,933
First State Bank, Forsyth	10,000	35,621	36,815
First Chouteau Co. Bank, Ft. Benton	2,500	28,114	27,297
First State Bank, Froid	15,000	12,942	17,243
Clarks Fork Valley Bank, Fromberg	15,000	27,416	25,015
First National Bank, Geraldine	....	4,898	6,446
First National Bank, Glasgow	50,000	246,444	104,815
First Security Bank, Glasgow	50,000	241,602	132,853
Exchange State Bank, Glendive	....	37,886	34,281
First Montana Bank, Glendive	9,000	22,027	20,445
Central Bank of Mont., Gt. Falls	50,000	54,633	233,883
Great Falls Nat'l. Bank, Gt. Falls	25,000	277,970	248,153
Montana Bank, Great Falls	30,000	351,773	286,890
First Nat'l Bank, Great Falls	50,000	283,551	148,303
First Westside Nat'l. Bank, Gt. Falls	30,000	223,814	223,814
Citizens State Bank, Hamilton	30,000[3]	44,570	47,782
Ravalli County Bank, Hamilton	15,600	50,524	50,284
Big Horn Co. State Bank, Hardin	25,000	37,452	36,164
Security State Bank, Harlem	....	29,758	30,149
Continental National Bank, Harlowton	....	16,228	17,440
Citizens Bank of Montana, Havre	30,000	146,061	145,377
First National Bank, Havre	25,000	130,086	55,642
First National Bank, Hinsdale	....	5,038	7,926
First National Bank, Hysham	....	6,127	7,489
Garfield County Bank, Jordan	25,000	32,212	31,320
Conrad National Bank, Kalispell	25,000	206,737	211,358
First National Bank, Kalispell	25,000	192,530	216,250
Yellowstone Bank, Laurel	....	26,720	38,911
First National Bank, Lewistown	25,000	55,496	57,790
Northwestern Bank, Lewistown	5,000	106,440	64,979
First State Bank, Libby	....	17,572	21,300
First Nat'l. Park Bank, Livingston	50,000[4]	86,120	115,798
Livingston State Bank, Livingston	40,000	95,778	107,329
First State Bank, Malta	....	28,241	45,645
Manhattan State Bank, Manhattan	10,000	22,887	22,523

*Certificates of Deposit shown are for September, 1962. If the amount of CD's in September, 1963 differs, the later figure is shown below.

[2] $50,000

[3] $50,000

[4] $75,000

APPENDIX D—(continued)

Name of Bank	TIME CERTIFICATES OF DEPOSIT*	SEPTEMBER 1962 AVERAGE DEMAND BALANCE	SEPTEMBER 1963 AVERAGE DEMAND BALANCE
First National Bank, Miles City	25,000	30,349	49,911
Miles City Bank, Miles City	35,000	92,249	95,789
First National Bank, Missoula	50,000	336,924	192,091
Western Mont. Nat'l. Bank, Missoula	50,000	253,199	223,694
Flint Creek Valley Bank, Philipsburg	....	27,174	27,391
First National Bank, Plains	....	27,058	26,377
Security State Bank, Plentywood	25,000	90,374	73,060
Security State Bank, Polson	....	44,377	62,561
Traders State Bank, Poplar	6,000	8,384	10,302
First Security Bank, Red Lodge	40,000	43,554	57,404
U. S. National Bank, Red Lodge	9,000[5]	31,345	55,799
First State Bank, Richey	15,000	11,581	17,256
Ronan State Bank, Ronan	15,000	35,733	37,240
Miners & Merchants Bank, Roundup	20,000	38,206	40,678
Citizens State Bank, Scobey	7,500	35,330	34,819
First State Bank, Shelby	10,000	75,628	69,802
Toole County State Bank, Shelby	5,000	69,873	60,269
Bank of Sheridan, Sheridan	20,000	14,848	22,744
Richland National Bank, Sidney	50,000[6]	63,804	80,323
Sidney National Bank, Sidney	50,000	78,811	79,304
Basin State Bank, Stanford	....	31,370	24,574
First State Bank, Stevensville	35,400	16,387	33,319
Lake County Bank, St. Ignatius	....	6,168	8,264
First State Bank of Mineral County, Superior	20,000	21,588	21,481
State Bank of Terry, Terry	10,000	15,747	17,652
First State Bank, Thompson Falls	....	19,325	17,762
Security Bank, Three Forks	20,000	19,020	24,661
State Bank of Townsend, Townsend	10,000	44,542	40,607
First National Bank, Twin Bridges	25,000	5,186	29,683
Farmers & Stockmans Bank, Valier	15,000	13,290	16,813
Farmers State Bank, Victor	4,000	26,806	23,671
First National Bank, Whitefish	....	69,438	54,651
Whitehall State Bank, Whitehall	20,000	13,850	28,863
First Nat'l. Bank, White Sulphur Springs	....	28,406	29,269
First National Bank, Wibaux	35,000	42,788	38,590
Citizens First National, Wolf Point	25,000	45,798	52,614
First State Bank, Wolf Point	....	90,649	76,777
Farmers State Bank, Worden	....	5,227	7,785
	$2,202,000	$8,298,887	$7,735,552

*Certificates of Deposit shown are for September, 1962. If the amount of CD's in September, 1963 differs, the later figure is shown below.

[5] $74,000
[6] $70,000